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STEVEN REINEMUND



HECTOR RUIZ

MANAGERS

...And The Worst

(P.55)

PLUS

- » THE NEW BOSSES
- » MANAGERS ON TRIAL
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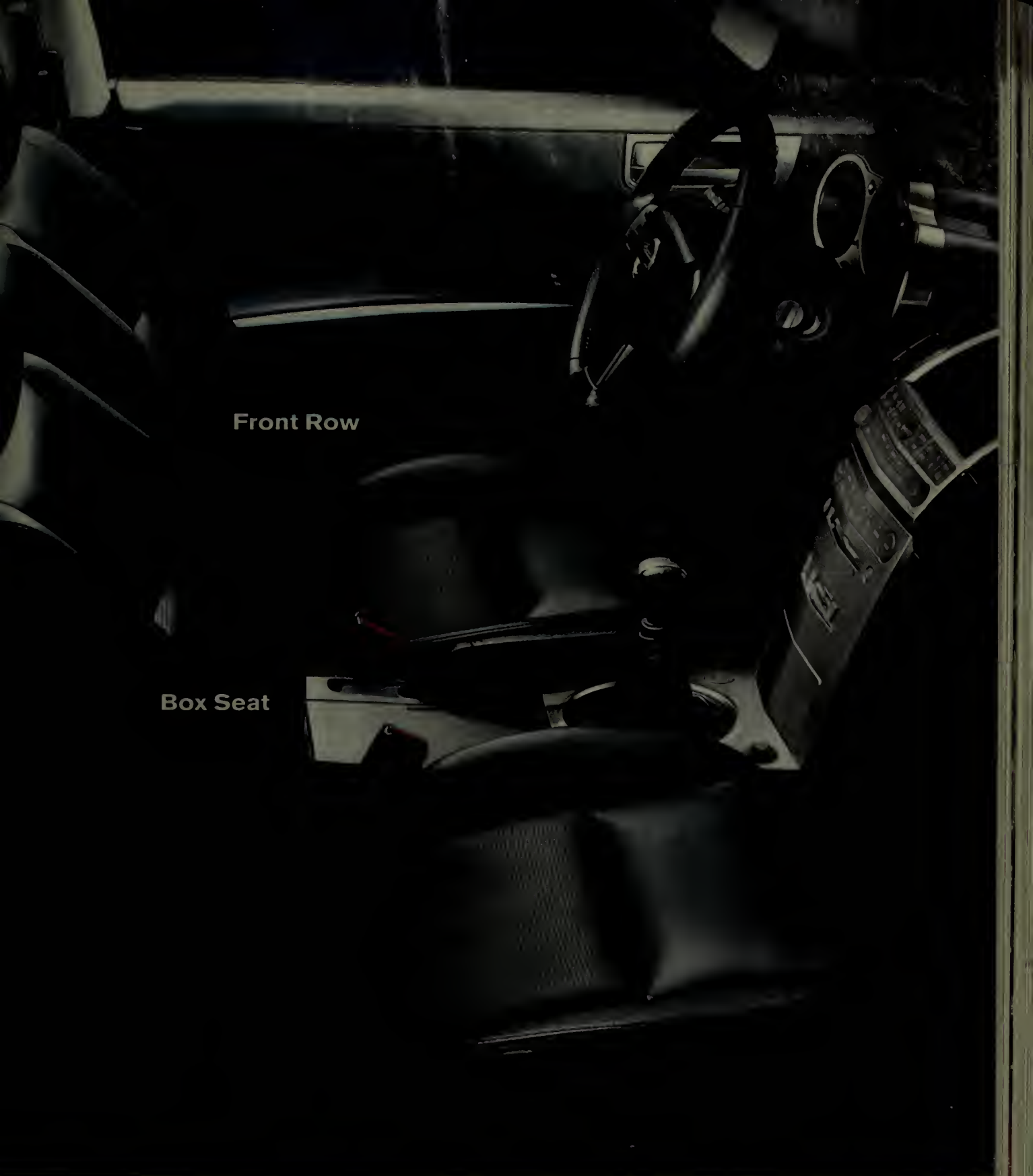
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A high-contrast, black and white photograph of the interior of a car, specifically the front row and center console. The image is dark, with highlights on the leather seats, the steering wheel, and the dashboard. The text "Front Row" is overlaid on the left side of the image.

Front Row

Box Seat

The 265-hp Nissan Maxima



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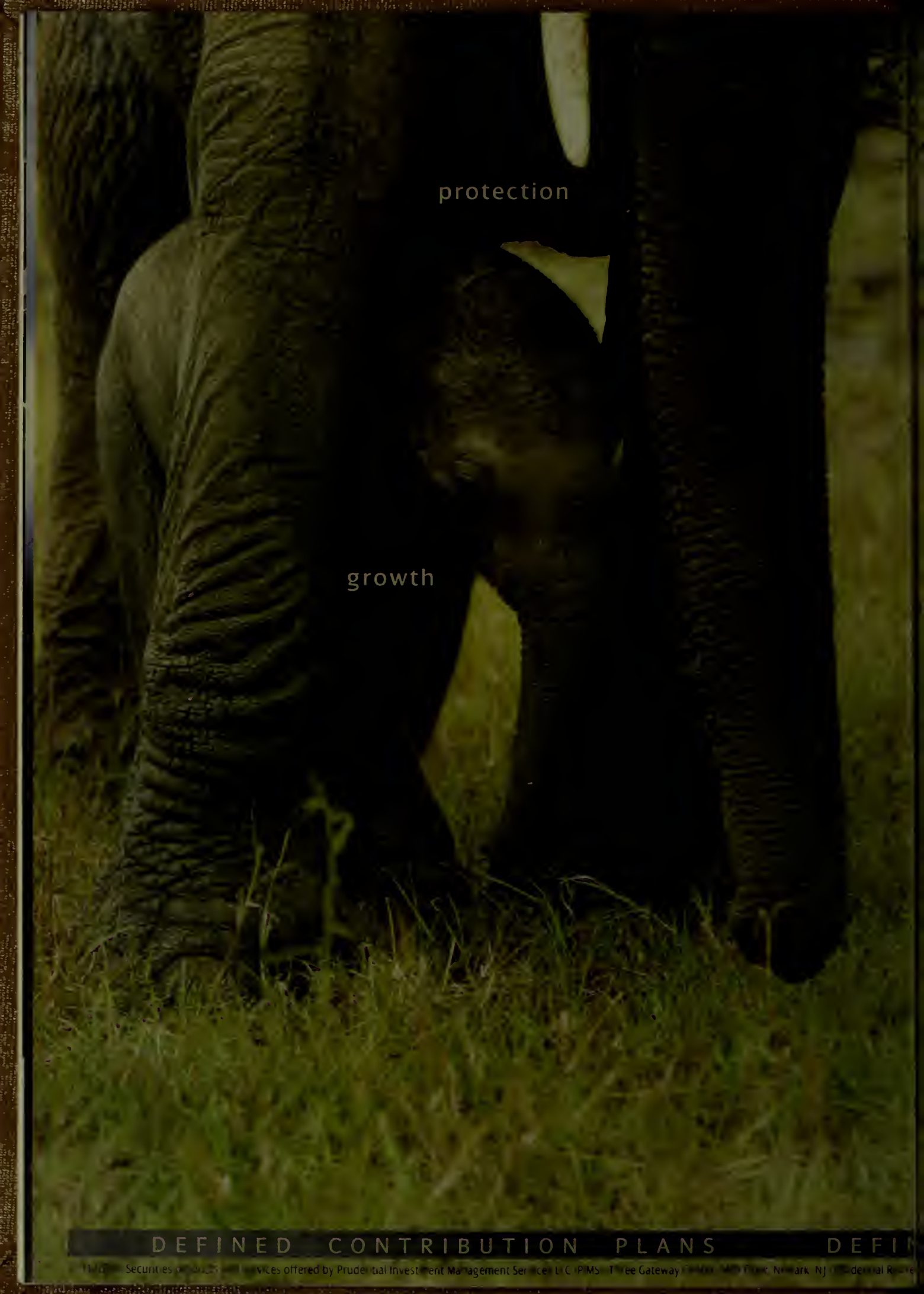
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Industry Outlook 2005
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When it came to our tasting of "white goods," the superpremiums ruled the day. Here, our top three in each category, plus our tasters' comments:

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How Candor Can Help Immunize Big Pharma

The drug industry needs to build "a culture of transparency," says BW Chief Economist Michael J. Mandel. That means releasing and publicizing all research studies, including negative ones



What to Watch in Europe

A rising euro, a housing market bubble that may be set to burst, Olympic dreams, new pollution limits and emissions trading, angst over a new EU constitution. A riveting year is shaping up

Can Gateway Reach Greener Pastures?

New CEO Wayne Inouye has impressed Wall Street with his cost-cutting and a renewed focus on PCs, but investors are still wondering if it can thrive long-term against HP and Dell in this tough market

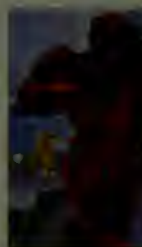


China as a "Global Consumer"

The country's changing role and growing power will be good for American businesses, say Fred Alger Management's Dan Chung and Zachary Karabell. And that will create investing opportunities with "maximum upside"

Bungie's Jump Into The Big Leagues

The brains behind the smash hit *Halo 2* for Xbox, this video-game developer has managed to retain some of its rebel spirit—even after being acquired by Microsoft and losing some key players



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"Today we made the decision to join the Third World."

—Andrei Illarionov, an economic adviser to Russian Prime Minister Vladimir Putin, slamming the sale of Yukos' main production unit to a government entity

EDITED BY BRIAN HINDO

MAIL TO THE CHIEF BIG BUSINESS SETS BEHIND BUSH'S BASH

CAUSE CORPORATIONS can't vote in the Presidential election—yet their top executives are limited to 100,000 individual contributions—mightily hard on Big Business to express its gratitude to the President of USA Inc. There's one whole large enough to drive several hundred businesses through: the Presidential Inaugural Committee. Companies and individuals are allowed to open their wallets to underwrite the coronation of George W. Bush's reelection, and as of now, 23 business interests

have anted up nearly \$8 million. At least 28 defense contractors, energy giants, financial firms, Big Tobacco, techies, and health-care companies have ponied up \$100,000 or more, according to a *BusinessWeek* analysis of the latest donor list posted on the 2005 inaugural Web site.

Among those giving a quarter-million bucks, the max set by the Bush team: **ExxonMobil, ChevronTexaco, Occidental Petroleum, Southern Co., United Technologies, Sallie Mae, and Altria.** While most have long histories of GOP loyalty, **Boeing and Qualcomm** execs and political action com-



BUSH Corporations gave \$8 million for his party

mittees gave generously to both parties—but the companies sent a six-figure check to the winning side after the election. —Richard S. Dunham

OLDEN CHUTES \$140 MILLION PAYDAY FOR FRANK RAINES

FORMER FANNIE MAE CEO Franklin D. Raines has quite ailded parachute to soften landing. In addition to \$10 million in severance payments, Raines, 55, gets a base salary of \$1.37

million. If he lives until 75, that's \$27.4 million. Add: \$21 million in stock already awarded, \$23.8 million in future stock payouts, a life insurance policy, and an additional \$23.8 million in performance-based options. That's on top of more than \$17.5 million paid to Raines since 1999. The grand total is worth \$140 million—not bad for just six years on the job. —Jessi Hempel

BLASTOFF One fuel ingredient shows up in our water



POLLUTION PATROL

Rocket Fuel Has Its Down Side

THE ENVIRONMENTAL PROTECTION AGENCY and the **Defense Dept.** are locking horns over perchlorate. A primary ingredient in rocket fuel and fireworks, the chemical has been found in at least 20 states—or 4% of the U.S. water supply. The EPA worries that levels found in drinking water near military bases may be unacceptable. That could make the Defense Dept. liable for hundreds of millions in cleanup costs.

The two have turned to the **National Academy of Sciences** to evaluate the risks. *BusinessWeek* has learned that the NAS will recommend this month a specific amount judged safe for consumption, instead of its usually more general guidance. Plenty is at stake: Adults can tolerate perchlorate, but it can block iodide uptake into the thyroid gland, an essential function that aids development in children. If the NAS's level is low, both the Pentagon and defense contractors may have to fund cleanups.

Contractors are hedging their bets. **Lockheed Martin, Kerr McGee, GenCorp unit Aerojet,** and perchlorate maker **American Pacific** are all setting aside reserves or doing cleanups while fighting perchlorate limits in Washington. Neither NAS nor Defense officials would comment.

—Burt Helm

EU PHORIA

WHAT'S 'TRADE UNION' IN CATALAN?

AN UNEXPECTED PROBLEM may cramp the European Union's expansion. When the EU added 10 members in 2004, the number of official



languages rose from 11 to 20. In this modern Babel, costs for document translation and interpreting services jumped from about 700 million (\$950 million) to 1.2 billion (\$1.6 billion) euros a year, estimate Jan Fidrmuc and Victor Ginsburgh of the **Université Libre de Bruxelles**. Already, some new policies have been delayed because the EU's staff of 2,400 swamped translators could not produce local versions fast enough.

As membership for Turkey and other candidates looms, linguists and economists from Oxford to Ankara are puzzling over ways to alleviate the bind while preserving the EU's multilingual principles. Economists Fidrmuc and Ginsburgh have devised a market-based solution: They suggest in a recent discussion paper that countries be given the chance to take the money slotted for translations and use it in some other, perhaps more productive, way. They figure that translations in English, French, and German would

satisfy the language needs of about 70% of EU citizens.

Critics, though, ask how the EU could enforce laws that Greeks or Italians, for instance, can't read. Others contend that the money allocated to language services pales against other categories, such as agriculture.

Beyond rising costs, a lack of capable translators is

another obstacle. To make matters worse, some EU states have put in requests to treat their minority languages as official: Catalán, Gaelic, and Basque, to name a few. Little political will exists to tackle the issue. And France opposes any changes, for fear they will favor English and German. For now, new EU head Jean-

Claude Juncker can still get memos in his native Luxembourgish. —Brian Hindo

LANGUAGE BIND
New EU chief Juncker

I-WAY PATROL

ONLINE HARVEST This holiday season, some altruistic givers barely lifted a finger. They used "virtual food drives" at companies such as **S** Microsystems, Accenture, and the Greater Chicago Food Depository. Web sites are set up for workers or clients who click on items, select how much to send, and watch the site tally the pledges for food depositories around the world. The donations are collected and food is bought in bulk. More than 225 drives, handled by software from Dallas' Aidmatrix, raised \$295,148 in 2004. Accenture alone has raised more than \$79,500 from 29 offices nationwide. The means may be virtual, but the results couldn't get more real. —Roger O. Crockett

DRAWN & QUARTERED





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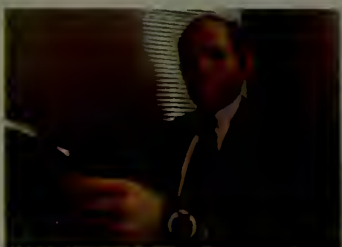
IN A YEAR MARKED by uncertainty—over Iraq and Afghanistan, the dollar, the fledgling recovery, and the election—it's hard to remember that 2004 did give us some things we can be sure about. Try our annual quiz on the year in business news:

- 1** What percentage of U.S. cows are now tested for mad cow disease?
A 0.1% **B** 1%
C 10% **D** 20%



- 2** Which General Electric alumnus delivered the best shareholder returns in 2004?
A James McNerney, 3M
B Tom Tiller, Polaris Industries
C Robert Nardelli, Home Depot
D David Cote, Honeywell

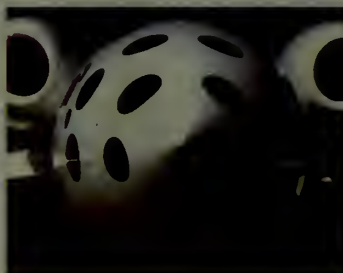
- 3** In her press conference to ask the judge for a speedy sentencing decision, Martha Stewart listed things she would miss behind bars. Which of the following was not named?
A goats **B** chickens
C horses **D** canaries



- 4** What was the euphemism given to kickbacks paid to insurance brokers, targeted by New York Attorney General Eliot Spitzer?
A "contingency fees"
B "compulsory assessments"
C "back-scratch fees"
D "convenience charges"

- 5** Which chief executive saw a record 45% of shareholders withhold their votes for him?
A Michael Eisner, Disney
B Michael Jordan, EDS
C Steven Burd, Safeway
D Lawrence Ellison, Oracle

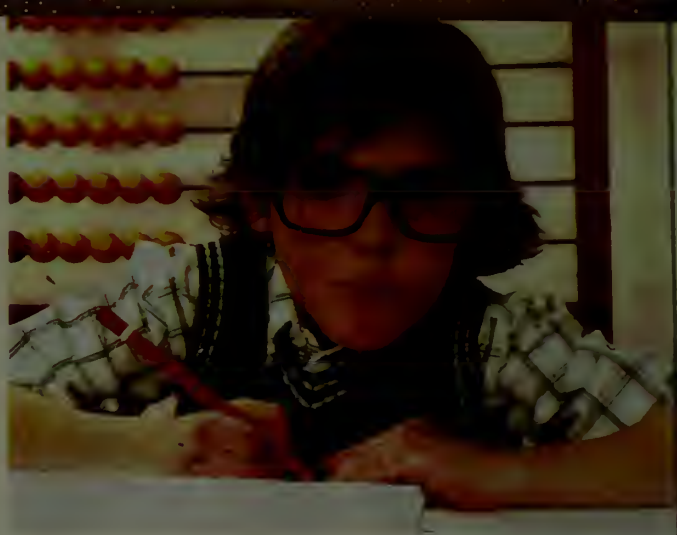
- 6** Royal Dutch/Shell Group slashed its estimate of proven oil and gas reserves by nearly 25%. It had relied on:
A Arthur Andersen to estimate its reserves
B a part-time auditor to check its reserves estimate
C 1960s-era geologic strata-sampling technology
D cutting-edge, but unproven, geologic strata-sampling technology



- 7** In June, SpaceShipOne became the first privately built vehicle to reach space—what fuel did it burn?
A rubber and laughing gas
B kerosene and liquid oxygen
C liquid hydrogen and liquid oxygen
D lithium pellets and hydrogen peroxide

- 8** Which of the following has licensed SpaceShipOne's technology and hopes to launch a space-tourism business in 2007?
A a new NASA spin-off company
B Emirates Airline
C All Nippon Airways
D Virgin Atlantic

- 9** The money Citigroup set aside for legal actions, including Enron and WorldCom-related liabilities, is what percentage of its \$18 billion in '03 profits?
A 1% **B** 12%
C 28% **D** 55%



- 10** Which stock group had the best performance in 2004?
A Internet retail
B gold mining
C fertilizers and agricultural chemicals
D semiconductors

- 11** Amid a sour market, which tech company cut its IPO price by 25% at the last minute?
A Shopping.com
B Google
C salesforce.com
D WebSideStory

- 12** Which of the following set a record in 2004?
A junk-bond issuance
B mergers and acquisitions
C initial public offerings
D all of the above



MATCH THE FINE

- 16** The FCC levied a record amount of fines for indecency this year—almost \$8 million. Match the offense with the fines it provoked:
- | | |
|--|----------------------|
| A Fox's <i>Married by America</i> reality show, which portrayed adults engaged to be wed in "sexual situations" | 1 \$1,750,000 |
| B CBS' Super Bowl halftime show, which featured Janet Jackson's "wardrobe malfunction" | 2 \$1,183,000 |
| C Clear Channel Communications' <i>Bubba the Love Sponge</i> radio show, for graphic discussions of sex and drugs | 3 \$755,000 |
| D ClearChannel, for Howard Stern's raunchy banter on his radio talk show | 4 \$550,000 |

- 13** Including a December request, how much has been appropriated for operations in Iraq and Afghanistan since beginning of the Iraq war?
A \$50 billion to \$100 billion
B \$100 billion to \$150 billion
C \$150 billion to \$200 billion
D more than \$200 billion

- 14** After early exit polls pegged John Kerry as the election winner, how did the Dow react?
A dipped more than 5%
B dipped about 1%
C rose about 1%
D rose more than 5%

- 15** Of the following executives embroiled in legal trouble in 2004, who was the subject of a criminal conviction and received the longest prison sentence?
A Martha Stewart
B Lea Fastow
C Dennis Kozlowski
D Bernard Ebbers

Answer Key: 1-a; 2-b; 3-a; 4-a; 5-a; 6-c; 7-b; 8-d; 9-c; 10-a; 11-b; 12-a; 13-b; 14-b; 15-b; 16-a; 2-b; 4-c; 3-d; 1

Peaking Generation Facilities

Energy Management Programs

Fiber Optic Networks

Health & Safety Compliance

Engineering Consulting

Air Quality Testing & Correction

Recommissioning

Plant Commissioning

Transmission & Distribution

Combined Heat & Power Plants

High & Low Voltage Power Systems

Steam Plants

Substation Design & Construction

Central Utility Plant Construction

Operation & Maintenance

District Cooling Plants

Capital Equipment

Advanced Metering

Mission-Critical Facility Expertise

Design/Build Services

Emergency Back-up Systems

Petrochemical Construction

Mobile Service

Technical Feasibility Evaluation

Measurement and Verification

Project Financing

Heating Ventilating/Air Conditioning

Renewable Energy Systems

Who has the power to help maximize your business?

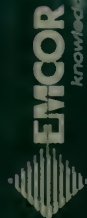
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Carly Fiorina could use a few good Marines....
 [HP's] option to 'stay the course' is made tough by a failure in teamwork"

—John Ledoux
 Jacksonville, N.C.



ARE HEWLETT-PACKARD'S GLORY DAYS OVER?

IN "CARLY'S CHALLENGE" (Cover Story, Dec. 13), you've forgotten one of the main points of contention about the acquisition of Compaq: Many were distressed by the absorption of a commodity technology company, because it strayed from Hewlett-Packard Co.'s long tradition of market-opening technical innovation. Now, HP is pumping up profits by, among other moves, reducing its research and development expenditures (your article says by taking advantage of "redundancies," whatever that means) in the pursuit of new ideas. The drama is playing out as many had expected: HP is groping about for "synergies" based on management moves and determined sales efforts, while the last harvest of the old, bold HP—the printer business—is steadily consumed.

—William W. McMillan
 Ypsilanti, Mich.

CARLETON S. FIORINA needs to rid HP of the unprofitable detritus that it has accumulated over the years. Taking a page from IBM's strategy guide and shifting to a service-heavy stance are the way to sur-

vival and shareholder satisfaction. Among others, the storage division, the cutthroat PC division, and the VMS division are prime candidates for rationalization.

—Israel Thorpe
 Sydney, Australia

IT'S NOT GOOD news when an \$80 billion "technology" company makes a majority of its profit from ink-jet cartridges. It's an \$80 billion office-supply company. The unique culture is gone along with the "technology."

—John Sullivan
 Granite Bay, Calif.

IT SEEMS TO ME that it's not only time to review HP's broad strategy and its inability to execute but also to consider replacing Carly Fiorina, the inspiring speaker, with someone with a proven track record in operations and execution. Five years is a long enough trial to drive change and improve performance. We only give the President the U.S. four years.

—Bill Dieter
 Fort Collins, Colo.

CARLY FIORINA COULD use a few good Marines. Your story about the value th-

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zen soldiers bring to business served in Iraq? Come work for us," Working Life, Dec. 13) made me think HP could use some reinforcements. My option to "stay the course" is made tough by a failure in teamwork—divisions can't get it together.

This Marine says: Kill friction with competition. Don't worry about end-to-end deals using all HP products and services. Instead, set up the best deal for the customer—put HP divisions in open competition with all rivals. This free-market competition will give the customer the best deal and naturally drive all HP divisions to greater efficiency.

If the business division heads can't handle competition, fire them and round up a couple of Marines.

—John Ledoux
Jacksonville, N.C.

LONG-TERM INVESTORS SHOULD PRAISE HANK GREENBERG

FROM JAN. 1, 1999, to today, American International Group Inc. has delivered a total return to shareholders almost five times as great as the Standard & Poor's 500-stock index (29.3% vs. 5.8%), hardly "disappointing performance" ("Quit while you're ahead, Hank," News: Analysis & Commentary, Dec. 13). While short-term speculators who trade pieces of paper back and forth may be unhappy about AIG's recent stock performance, long-term investors can only be grateful to CEO Hank Greenberg.

During that same period of time, AIG's earnings per share grew from \$2.34 to an estimated \$4.40 this year, shareholder's equity from \$39 billion to approximately \$101 billion, and market capitalization from \$101 billion to \$180 billion. Oh, and the company also weathered the terrorist attacks of September 11, a recession, and Florida hurricanes, all while maintaining an AAA balance sheet. So, what's about AIG needing a "shakeup"?

—Shelby M.C. Davis
Chairman Emeritus
Davis Advisors
New York

COMPARING AMERICA FOR HIGH-TECH OPPORTUNITIES

MAKING UP trade theory" (Special Report, "The China Price," Dec. 6) offered only anecdotes and factoids, tenuously suggesting that trade theorists may soon abandon the free-trade paradigm. No economy has ever grown or prospered by cutting itself off from competition. Management guru Peter Drucker says that foreign labor has less influence on

CORRECTIONS & CLARIFICATIONS

In "Will they get the gray out?" (Up Front, Dec. 27), we should have noted that a Rite Aid spokesperson says the company obtains its hair-care products from legal sources.

America's ability to compete globally than do our domestic costs for taxes, regulation, health care, energy and, especially, litigation. We must control these costs, strengthen and make permanent our R&D tax credit, and better develop our math and science teachers so they can properly connect today's students with tomorrow's high-tech career opportunities.

We also must invest in older workers' adjustments to changing skill demands and insist that our trading partners play by established global rules. But we'll foolishly jeopardize both domestic and international growth if we try to isolate our economy from the rest of the world.

—Frank Vargo
Vice-President for
International Economic Affairs
National Association of Manufacturers
Washington

NEWMONT IN INDONESIA: MORE THAN 'GREENWASHING'

IN "THE TOP givers" (Special Report, Nov. 29), you unfairly and incorrectly ascribe base motives to Newmont Mining Corp.'s philanthropic activities, particularly in Indonesia. For the record, Newmont has been engaged in extensive community development programs in Indonesia for the past 10 years. This activity includes building roads, bridges, schools, sports facilities, libraries, and health centers, among other things. We work closely with the local government authorities, various nongovernmental organizations, and other international entities to coordinate and implement these projects and programs. For *BusinessWeek* to label our ongoing and thoroughgoing community-development efforts as "greenwashing" misrepresents what is, in fact, exemplary corporate citizenship.

—Chris Anderson
Group Executive for
External Relations & Social Responsibility
Newmont Mining Corp.
Denver

HOW THE FDA CAN PREVENT ANOTHER VIOXX

AS A MEDICAL informatics specialist (combining medicine with postdoctoral-level information science and computing

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training), as well as a former Merck & manager, I view the Vioxx controversy with concern ("How to prevent another Vioxx," News: Analysis & Comment, Dec. 13). Post-marketing surveillance programs fail to produce any data at the practitioner does not realize a problem may be due to a drug—and the likely the situation in a majority of cases.

The Food & Drug Administration moves to improve the way it responds to risks from medical products, including better "data-mining," is a step in the right direction. My concern is that overconfidence in such initiatives may dilute the resolve needed for the fundamental and daunting task of implementing comprehensive electronic medical record (EMR) systems in clinical settings that could provide a solution to long-term postmarketing drug follow-up.

—Scot M. Silverstein, MD
Lansdale, PA

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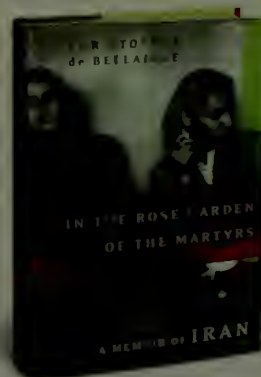
IN THE ROSE GARDEN OF THE MARTYRS A Memoir of Iran
By Christopher de Bellaigue; HarperCollins; 283pp; \$26.95

The seminal event shaping the mind-set of today's Iran may have come more than 1,300 years ago. That's when the Imam Hossein—the grandson of the Prophet and, in the view of Shia Islam, his rightful heir—was murdered by the forerunners of today's Sunnis, who now constitute

a majority of the world's Muslims. In Iran, though, most people are Shiite. An obsession with this history, theorizes Christopher de Bellaigue, has helped produce an Iranian culture that places an unhealthy emphasis on death and martyrdom and defiance of outsiders. "Iran mourns [Hossein] on a fragrant spring day, while watching a ladybird scale a blade of grass, while making love," he writes in his highly original and disturbing portrait of the Islamic Republic, *In the Rose Garden of the Martyrs*. "This was the case fifty years ago, long before the setting up of the Islamic Republic, and will be the case fifty years hence, after it has gone."

Of course, no one knows how long the Islamic Republic will last. But in the meantime, the clerical regime has exploited the society's cultural and religious ethos to carry off one of the more thorough revolutions of modern times. That has left Iran in a pretty depressing state, with an unaccountable and often irresponsible leadership and an economy that's still recovering from the disruption. All of this is deftly captured by De Bellaigue, a writer for *The Economist* and other publications who lives in Tehran, is wed to an Iranian, and speaks Persian. The author has immersed himself in the society and effectively describes his acquaintances' experiences of the revolution and its aftermath.

De Bellaigue is not squeamish about whom he befriends, a characteristic that allows him to see how the revolution played out not only from on high but also from street level. One of his chief informants is a fortyish man whom the au-



thor calls Mr. Zarif. As a te in the late 1970s, Zarif joined a group of toughs belonging to Hezbollah, or Party of C in an orgiastic session of breast-beating and chanting "Hosseinhosseinhossein! seinhosseinhossein." After that, Zarif paid little attention to his studies. Instead, during these early days of the revolution, the young zealot terror-

Iran is still in the grip of an ancient killing

ized those students and teachers at school whom he suspected of communist or other undesirable leanings. Eventually the principal became frightened of the boy—and ashamed of his own fear. The kid of fifteen had become more powerful than he was."

Zarif talked his way into a Revolutionary Guard unit just in time for the horrifically bloody war with Iraq, which consumed the 1980s. The hostilities represented the fullest expression of Iran's death wish. De Bellaigue blames the Iranian leadership and, in particular, former President Hashemi Rafsanjani, who takes some of de Bellaigue's harsh hits, for prolonging the war far longer than necessary as a way of justifying political excesses at home.

An opportunity for martyrdom—that was how the leadership portrayed the war. Such propaganda was certainly useful in persuading tens of thousands of men to charge ahead to almost certain death. The families of martyrs were paid off: The relatives enjoy such privileges as V.I.P. treatment at national cer-

tions and discounted trips to Mecca. Sixteen years after the war ended, its faces are everywhere. Many Tehran streets are named after martyrs, and their photos are displayed in parks. The revolution's apogee. The government is trapped in the past with little interest in the future. "The revolution is everything, and it has already happened," de Bellaigue writes. The regime may be exhausted, but it is capable of dealing ruthlessly with anyone it perceives to be a threat. In 1998, Gholam Reza Forouhar, leader of a small opposition party, and his wife, Parvaneh, were found butchered in their home, one of several such extra-judicial

killings, probably by government agents. These sparked a wave of revulsion and inquiries as part of a wider reform movement that failed, but only medium-size fish were punished. The most prominent investigative journalist, Akbar Ganji, who pointed the finger at Rafsanjani, was tossed in jail. Rafsanjani remains hugely influential. Near the end of the book, de Bellaigue visits Ali-reza Alavi Tabar, a reformist editor who has started a dozen or so newspapers only to have them shuttered. "I'd never seen his confidence waver in ultimate victory" by the reformers, de Bellaigue writes. Winning, Tabar thought, "was a matter of time." But it could be a long time. ■

-By Stanley Reed

Brief

Wright's Angles

FRANK LLOYD WRIGHT

by Ada Louise Huxtable; Viking; 251pp; \$29.95

Despite his oft-repeated credo of making "truth against the world," Frank Lloyd Wright was one of the most ingenious liars of the 20th century. He was, moreover, a deadbeat dandy, a carefree mooch, and a very public wreck. He was arrested and jailed under the Mann Act, which forbade transportation of women across state lines "for immoral purposes." Whether in his beloved Wisconsin hills, his remote Arizona desert, or in his midtown Manhattan suite at New York's Waldorf-Astoria Hotel, he lived as an American Baron, with his extravagant needs and vast pile of unpaid bills largely taken care of by backers. Throughout his life, he maintained what he called an "honest arrogance" and went hand-in-hand with his nearly unquestioned title as the greatest American architect. In a career that stretched from Benjamin Franklin's Presidency to the end-to-last year of the Eisenhower administration, Wright's was a life lived big, bold, and large.

It's the genius of the Penguin Lives series to match such a subject with a particularly appropriate biographer, *The Wall Street Journal* architecture critic Ada Louise Huxtable. In 251 short pages, Huxtable manages to synthesize the

considerable research into Wright and his work, to mediate the conflicting versions of Wright's "truth," and to bring a fresh point of view to his prolific final two decades. This *Frank Lloyd Wright* is a welcome, enlightened addition to the library of Wrightiana.

Wright's life was marked by well-practiced eccentricities and personal tragedies, including the 1914 ax murder of his lover and her children by a deranged servant. In counterpoint, there is that compelling body of work, most of which survives as evidence of both his genius and his perseverance. The shooting star of the last years of the 19th century—breaking "the box" of the Gilded Age house with his vision of an open, organic architecture—had neither clients nor commissions by the end of the 1920s. Then, in the depths of the

Great Depression, he began shaking "out of his sleeve," as he often put it, such designs as Fallingwater, his Pennsylvania masterpiece. Such a rebound, coming even as he was pushing 70, represents one of the great professional and artistic resurrections. And it's the stuff of grand biography.

This is one of at least six new Wright titles in the past

year alone. Not that it was an anniversary year: Wright, in 2004, would have turned 137—although the compulsive fibber in him would likely have admitted to only 135. ■

-By Ray Hoffman



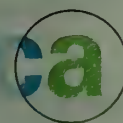
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Masanobu Suzuki President and CEO NTT Communications Cor

On Course to A Quintessential Global IP Services Company

Within just six years of its birth as a conventional long distance and international telephone company, Japan's NTT Communications Corporation (NTT Com) is going strong as a leading global data communications player.

Managing a global business is like scaling a lofty mountain with no peak in sight, observes Masanobu Suzuki, President & CEO of NTT Communications Corporation (NTT Com), Japan's biggest provider of long distance/international telephone and data communications services. "You just have to keep climbing – step by step, higher and higher – in an endless, tireless effort to get there some day, somehow."

The climb is particularly tough in a fiercely competitive era of rapid technological advances in which services utilizing today's innovative ideas can often become mundane by tomorrow. But there are gratifying moments at times, notes Suzuki – such as last November when his firm successively received the "Best Global Carrier – 2004" award from the organizers of the London-based World Communication Awards, and shortly afterwards was named the Asia-Pacific region's top carrier in an authoritative annual international survey reflecting the opinions of data communication service users across the area.

Such recognition mirrors the high rates of approval by NTT Com's global customers for whom it takes great pride in offering IP (Internet Protocol)-based services

embracing four core values – solution, security, network management, and global services which extend to 140 countries and cities.

"It is most gratifying for a late comer like us (in the global data services market) to be recognized by our peers," says Suzuki beaming his satisfaction. "We have been doing our best to win our clients' approval and appreciation of the scope and quality of our services. This also proves the business strategy we have been pursuing since our inception in 1999 has been on the right track."

Key Ingredient for Globalization: Strategic Partnerships with Local Players

NTT Com, headquartered in Tokyo with a combined operating revenues exceeding ¥1,000 billion (approximately US \$10 billion), was founded as a fully-owned long-distance voice services subsidiary of NTT (Nippon Telegraph and Telephone) Corporation – one of the world's largest telecommunications groups which for long remained a government corporation until privatized in 1985. NTT Com was created when

nt company was subsequently reorganized in 1999 Japan's heavily protected telecommunications or was further deregulated.

NTT Com's first man at the helm, Suzuki is a vision-ascinated by the magic of technological innovation his youthful days half a century ago when a just-oped anti-tuberculosis drug saved his life.

Long before assuming presidency, he had already luded that the future of the conventional voice ces – domestic or international – was marred with advent of the Internet era, and decided that the ling NTT Com must develop a bold new survival gy. His decision: transformation of NTT Com into or global IP player by changing its jaded corporate re devoid of vigor and a business process to tively meet the rapidly changing needs of the IT era. Suzuki wasted no time. Within a year, he found a

er that could be a driving rst. In 2000, NTT Com acquired based Tier 1 Internet provider o to leverage their extensive essage solutions network, centered and hosting services spanning the icas and Europe. The acquisition ed NTT Com to combine its own Pacific data services network Verio's, instantly becoming one e world's leading carriers of IP c. It also won the freshman firm op position as a provider of d hosting in the U.S.

n addition, forming mutually rding strategic alliances with endable local players around the d constitutes a crucial corner- to successfully globalize data ces operations, Suzuki points "You need good alliances, euse developing your own infra- ture is simply too costly these Moreover, you can get expert e from your partners and ces that are well versed in the tions of the local markets in n you wish to operate." Suzuki ontinue to seek out such teaming rtunities to bolster services and y worldwide.

Building A Seamless High-Quality Global Internet Service Network with Verio

I am delighted that our partnership with Verio has icked out very well," says Suzuki. "This partnership rovided us access to a solid Internet backbone they d developed, and simultaneously helped us maintain

the high standard of quality services we take pride in. Timely partnering constituted a decisive turning point for us, because it has given us the basis of trust the market places in what we have to offer, as we seek to fortify a seamless global Internet service. We plan to maintain a lasting partnership with Verio."

Suzuki is stepping up his efforts to solidly establish his firm as a leading global IP solution company under a strategy he put forward in 2003 to meet the growing global needs and sustain his firm's growth. New services now account for almost half of his firm's operating revenues, which he hopes to increase to "60 to 70% within a few years." "When we reach that 'critical point,' we can call ourselves a full-fledged global IP services company for the first time," says Suzuki, adding with a smile: "Until then and thereafter, however, there will be no stopping for us."

Partnerships and Quality Control – Two Key Ingredients of Success in Globalization

A frequent featured speaker at conferences both at home and abroad, Masanobu Suzuki, President and CEO of NTT Communications Corporation (NTT Com) headquartered in Tokyo, was a panelist last fall during a forum in Beijing, China, where chief executive officers of 44 major global corporations representing 13 nations congregated to discuss a wide range of matters relating to the revolving role of CEOs in a rapidly changing world.

Underlining the crux of NTT Com's globalization scheme on a panel discussing the blueprints for strategic and organizational changes, Suzuki articulated to a packed multinational crowd of 600 the importance of mutually rewarding strategic partnerships and a consistently high level of service quality as "the two key factors of our success as a global ICT (information and communications technology) company."

"Simple though it may sound," noted Suzuki, "(we make) absolutely sure we provide our customers and clients with dependable, one-stop information and communications services through partnerships and quality control."



Fellow panelists at the 8th BusinessWeek CEO Forum in Beijing, China, last November 9-10 (left to right): John Thompson of Symantec Corporation; Masanobu Suzuki; Helmut Panke of Germany's BMW; Edward Madden of Fidelity Employer Services Company; Liu Chianzi of China's Lenovo Group; Kathleen Corbet of Standard & Poors.



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BY STEPHEN H. WILDSTROM

Desktop Search: The Game Is Afoot

Just a few months ago, Windows users who needed something better than Microsoft's clunky search feature to locate e-mail messages or files on their computer had to seek out—and usually pay for—third-party software. Now Microsoft Corp. has joined Google in providing a free desktop search tool, and Yahoo! has announced plans to do the same, and more are on the way.

On Dec. 13 a test version of Microsoft's entry arrived as part of a new MSN Toolbar. This is a critical step in the evolution of local search because the odds are good that the technology will eventually be built into Internet Explorer, perhaps into Windows itself. Yahoo! will make a version of X1, an excellent stand-alone search application, available free of charge in January. And Earthlink will incorporate X1 into the e-mail software it provides to its Internet service subscribers. America Online has been rumored to be negotiating with search software maker Copernic, but it says only that desktop search will be part of a new AOL browser that is under development.

For anyone frustrated by the difficulty of finding something among thousands of e-mail messages and files stashed on a typical business or consumer PC, this sudden proliferation of desktop search may end up creating difficult choices. Each of the search programs has its strengths, and it would be a good thing if you could just pick the one that's best for a given job—the way you might use multiple browsers or e-mail programs. Unfortunately, you can't safely run more than one desktop search program on your computer. These programs, which index the contents of your hard drive, can interfere with one another, meaning none of them will work properly.

THE MICROSOFT OFFERING is part of a new MSN Toolbar including desktop search, Web search, and a pop-up blocker (which duplicates that feature in the latest version of Internet Explorer). There's also a tool that stores personal information, including credit card numbers, and inserts it automatically in the appropriate fields in Web forms. There are quick links to Hotmail, Microsoft Money, and other Microsoft sites as well.

The desktop search itself appears in its own window. It offers options for restricting search to mail, various kinds of documents, music, or pictures. This is a powerful tool, but it comes with a confusing user interface. For example, you have



to know that clicking on the "Images" item above the box where you enter search terms tells the program to look for pictures on the Web. If you want to search for images on your computer, you have to click "Pictures & Videos" below the box. And the item called "Files" in that upper menu finds terms in file names, but not their contents. Like Google Desktop, MSN lists document titles (or e-mail information such as subject and sender) and a snippet of the body text. An icon to the left of each entry indicates the type of document found.

**New tools
have various
strengths,
but you can
only use one**

Not surprisingly, MSN Desktop is especially efficient at searching Microsoft Outlook and Outlook Express folders, finding calendar items and contacts as well as messages. Unlike Google, it does not search copies of Web pages stored on your computer, so it does not find messages from Web services such as Hotmail. Although MSN Search claims to examine spreadsheet contents, it was unable to locate text in an Excel file that Google found without trouble. Neither MSN nor Google currently can search the contents of Adobe Acrobat (PDF).

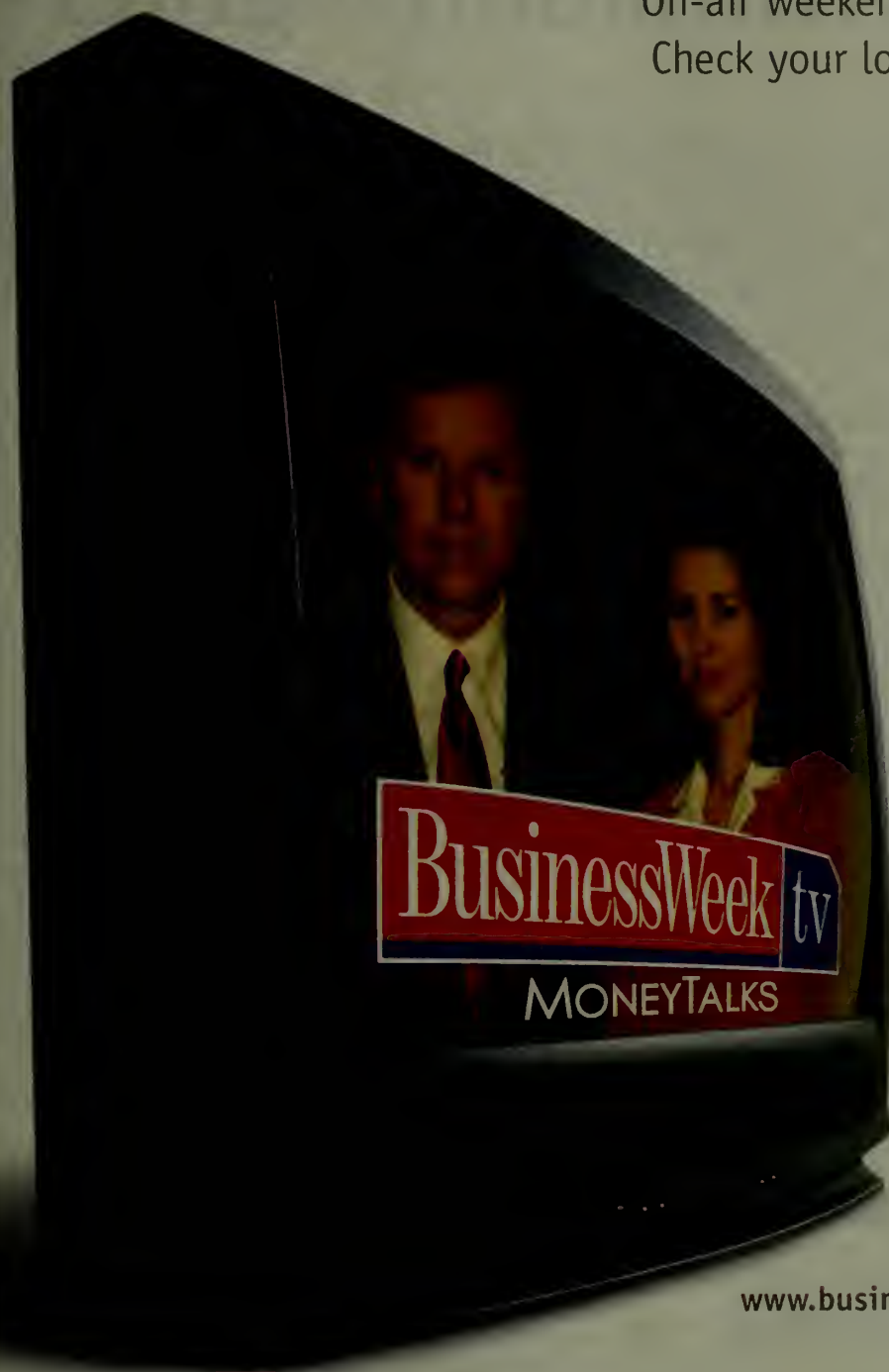
While both these programs can be useful, I would give either for X1, which I have come to depend on since writing about it last spring (BW—Apr. 26). I use it mainly to search e-mail, and I especially like the way it can cram information into two or three dozen messages into a window. The new version to be supplied by Yahoo! features improved performance and a cleaner design. And free sure beats the current \$75 price. The choice of a desktop search product really depends on how you plan to use it. It's just a shame you can't run them all. ■

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BY GLENN HUBBARD

A Gold Medal for the Fed's Inflation Fighters

The New Year offers a time for New Year's resolutions. One good resolution is to keep doing something healthy for yourself, even if you've been doing it so long it seems routine. The Federal Reserve's 20-year successful effort to rid the U.S. economic system of inflation is something Americans should value. The Fed's victory over inflation constitutes what is, in effect,

the biggest tax cut for investment over the past two decades.

That inflation is associated with macroeconomic instability is clear in the memories of those who lived through the Great Inflation of the 1960s, '70s, and early '80s. Inflation's rise was accompanied by a stop-go monetary policy with some serious downturns. There were two small and two large recessions from 1969 to 1982. During this long period, equity values of U.S. companies stagnated, as did growth in living standards.

As a textbook author and teacher of financial markets, I know that students' interest in inflation has faded. Recent years have instead seen more attention to deflation—a falling general price level—and an appreciation of the Fed's role in averting financial crises by maintaining liquidity, as it did after the terrorist attacks of September 11, 2001.

This shift in perception is understandable, as inflation peaked in 1979, gradually declining to about 2% a year today. This period of gradually decreasing inflation has been associated with the mirror image of the macroeconomic events of the years of great inflation. We've had larger expansions and only two mild recessions since 1982, plus rising equity values and more pronounced increases in living standards. Business leaders worry more about losing pricing power from globalization and e-commerce than they do about inflation.

But let's remember the key role that monetary policy has played in reducing inflation and interest rates, and improving economic outcomes. With lower inflation, aggressive tightening of monetary policy by the Federal Reserve has become rarer, smoothing out the business cycle. Fed credibility in battling inflation has lowered market interest rates by making investors less worried that rising prices will cut into the value of their investment. In addition, because of the Fed's commitment to low and steady inflation, interest rates have become less volatile. That, too, makes investors more willing to accept lower rates.

High inflation acts as a tax on investment, raising rates, increasing the cost of equity-financed investment, and reducing corporate equity values. Capital gains generated by a rising price level are taxed the same way as gains arising from increases in expected future profitability. And because depreciation allowances are based on historical cost, inflation reduces the real value of depreciation allowances. It is these

effects of inflation that reduce investment.

Using data on the U.S. corporate sector, Darrell Cohen, Kevin A. Hassett, and I estimated that a decline in inflation four percentage points—as during the 1990s—would reduce the cost of capital enough to lift business fixed investment 6.5%. This increase in capital accumulation affects living standards by boosting output per worker and raising sustainable real consumption per capita. In the case of a four-percentage-point decline, this gain would be equivalent to a gain in consumption per person each year of more than 1% permanently.

Of course, there are other ways that the government can reduce the inflation tax on investment. One way would be to

By holding inflation down, the Fed has boosted the economy

index parts of the business tax code to take price changes into account. An alternative approach would be to tax income once (eliminating investor-level taxes on dividends and capital gains) and to allow businesses to write off their full capital investment in the year it is made. Such shifts would extend the changes in the tax code championed by President George W. Bush and would fit easily into the framework for tax reform.

But it is the Fed, wisely insulated from the political process, that has provided the greatest and most competent leadership in reducing taxes on investment. Maintaining the gains from low inflation requires a continued Fed commitment to price stability. Explaining to the public the costs of even modest rates of inflation is a vital part of Fed communication. So, too, is anchoring inflation expectations with a description of the range the central bank finds acceptable. The Fed has done a remarkable job in cutting the inflation tax on investment. It should not take that effort for granted. ■

Glenn Hubbard is dean of Columbia Business School. He chaired the Council of Economic Advisers from February, 2000, to March, 2003 (rgh1@columbia.edu).

JAMES C. COOPER & KATHLEEN MADIGAN

Financial Fuel For the Economy's Engine

accommodating conditions—and the expansion—stem mostly from Fed policy

U.S. ECONOMY The tag line in the old Timex commercial also applies to this three-year economic expansion: It takes a licking and keeps on ticking. Despite the terrorist attacks, corporate scandals, war in Iraq, and soaring oil prices, the economy has kept performing, and growth has accelerated each year since the 2001 recession. Why?

Extremely accommodative financial conditions have fueled demand, and these supports will continue their growth-building ways in 2005.

Accommodative financial conditions set this expansion apart from all the others. They stem mostly from the gradual amount of easing of monetary policy by the Federal Reserve in an effort to assure that deflationary forces would not take hold in the wake of the stock market bust, the recession, and a world awash in excess production capacity. The Fed has also adopted a willingness to communicate its goals clearly to the financial markets, especially to bond traders. This transparency will be even more evident in 2005, thanks to changes in how the Fed reports its policy decisions. Make no mistake, rates at both the short and long ends of the yield curve will rise in 2005 as the Fed keeps raising its target for the federal funds rate. However, keep in mind that the real funds rate—the target minus inflation, using the Fed's preferred price index—is still at zero (chart). That's a sign Fed policy is highly conducive to economic growth.

The Fed has a long way to go before it moves the federal funds rate back to "neutral," a level that no longer stimulates growth. Economists generally put that rate in the neighborhood of 4%, given low inflation. And with rates likely to edge only slightly higher, long-term rates, which are crucial to housing demand and corporate investment, probably won't rise as much as short rates and will remain at comfortable levels.

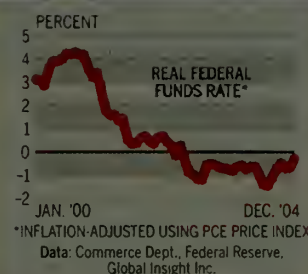
IT'S NOT JUST LOW RATES. Other signs of easier financial conditions include the rally in stock prices, which gives companies greater access to equity financing. The lower dollar makes U.S. assets more attractive to foreign investors. And perhaps most important, investors sense a less risky investment climate, suggested by the narrowing in the difference in yields between corporate bonds and riskless Treasury bonds. Put all together, especially at a time when Corporate America is sitting on a mountain of cash, and it creates a uniquely explosive combination for new mergers and acquisitions (page 32), in addition to an extremely growth-friendly climate.

To be sure, the Bush tax cuts also made possible a welcome dollop of demand in 2003. But as the fiscal stimulus faded in 2004, consumer and business spending did not weaken, as had been widely feared. Instead, consumers increased their buying at the same 3% clip as in 2003, and business outlays for new equipment and buildings grew almost 9%, nearly three times faster than

in 2003. The reason for that strength is ready access to credit, equity financing, and a gusher of corporate cash flow.

The momentum continued as 2004 ended. The Conference Board reported that its index of consumer confidence jumped almost 10 points in December to the highest level in five months. Monthly data

FED POLICY: STILL EASY AFTER FIVE RATE HIKES



through November and holiday sales reports suggest real consumer spending grew at an annual rate of 3% to 4% in the fourth quarter. Strong buying just before and right after Christmas also helped retailers' fortunes.

In addition, factories were busier. Industrial output rose for the second month in a row, and business demand for capital equipment continued to increase. Bookings for nondefense capital goods other than aircraft grew by 1.8% in November. And despite the drop in November housing starts, builders in early December were upbeat, as the National Association of Home Builders' survey rated market conditions the best in more than a year.

ONE REASON FOR BUILDERS' OPTIMISM is the current low level of long-term interest rates. At the end of 2004, the yield on 10-year Treasury bonds was about where it was a year earlier, despite the backdrop of solid economic growth, an uptick in inflation, and five quarter-point rate hikes taken by the Fed.

But to understand the bond market right now, you must look beyond the ups and downs in the economic data, oil prices, and the price indexes. Certainty reduces

volatility. And a unique difference in this expansion is that the Fed has given the bond market an unusually clear road map for future Fed actions and inflation.

First, through a new openness toward policy, the Fed has put its pattern of interest-rate hikes on a gradual and predictable path. Ever since the Fed began lifting rates in June, the market has come to expect a quarter-point increase in the federal funds rate at almost every meeting, an expectation that should remain in place in 2005.

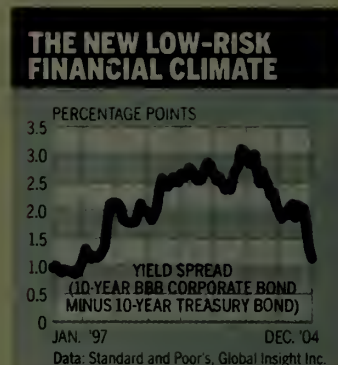
The Fed is moving toward even more openness in 2005. Policymakers will now release their minutes just three weeks after each meeting, instead of waiting six to seven weeks. This means that investors will be able to read the Fed's rationale for each policy decision before the next meeting rolls around. These timelier minutes could well become market movers. The first such report, on the Fed's Dec. 14 meeting, will be released on Jan. 4.

Second, the Greenspan Fed has achieved an unprecedented degree of credibility as an inflation-fighter. Inflation expectations are a critical component of bond yields. But despite above-trend economic growth, surging oil prices, and rising commodity prices, inflation expectations remain low—and so have bond yields.

PERHAPS THE MOST ENCOURAGING sign that financial conditions will remain supportive is a new attitude toward risk, as seen in the sharp narrowing in credit-quality spreads. During the stock market bust, the recession, and the corporate scandals, the spread between a medium-grade, BBB-rated corporate bond and a

riskless 10-year Treasury note widened to a record 3.1 percentage points. But by the end of 2004, that spread had shrunk to only 1.1 percentage points (chart). That was the lowest since 1998—one of the go-go years of public offerings and dealmaking.

Of course, today's accommodative environment could quickly change should some new calamity, such as a sudden crash of the dollar, beset the economy. Another wild card for bond yields is the degree to which foreigners, especially central banks, continue to buy U.S. Treasuries, most notably in their efforts to keep their currencies pegged to the greenback. Recent



studies by economists at UBS Securities and by the Federal Reserve suggest that such purchases may tend to lower Treasury yields, although the extent of the impact is hard to pin down.

Despite these risks, U.S. financial conditions ranging from low interest rates, a declining dollar, and an upsurge in the stock market are the most supportive in many years. With that heavy amount of financial lubricant greasing the economy's wheels, don't be surprised if the economy racks up another year of solid growth in 2005. ■

ISRAEL

A Bunch of Blooms in the Desert

AFTER THE WORST recession in the country's history, Israel is staging an economic comeback. A rise in global demand and dramatic improvement in the security situation helped real gross domestic product to grow by about 4% in 2004. And prospects for 2005 look equally good.

A 20% jump in exports led the 2004 recovery. Gains were especially strong in high-tech gear, such as software and semiconductors, which account for half of Israel's industrial exports. Tourism, private consumption, and construction also added to growth.

The venture-capital industry, which closely tracks the high-tech industry, saw its own strong recovery. Investments

in startup companies rose by nearly 50% in 2004, to \$1.5 billion. The renewed interest in local startups has led Israeli venture firms to raise over \$1.2 billion in new investment funds.

On the security front, progress was being made even before the Nov. 11 death of Palestinian leader Yassir Arafat. The partially completed fence, which runs mostly near the pre-1967 border, though controversial, has

prevented many suicide bombings, and the Israeli army has had more luck in thwarting attacks.

With the recovery under way, the jobless rate is inching down, though it remains high at 10.1%. Prices are rising by about 1%, giving Israel one of the lowest inflation rates globally. Better

growth and low inflation has lifted the shekel to its highest exchange rate against the dollar in three years.

The shekel's strength has enabled the Bank of Israel to cut rates. On Dec. 27, the central bank trimmed the discount rate to a record low of 4%. Plus, the government cut spending and reduced the deficit from 5% of GDP in 2003 to about 3.5% in 2004.

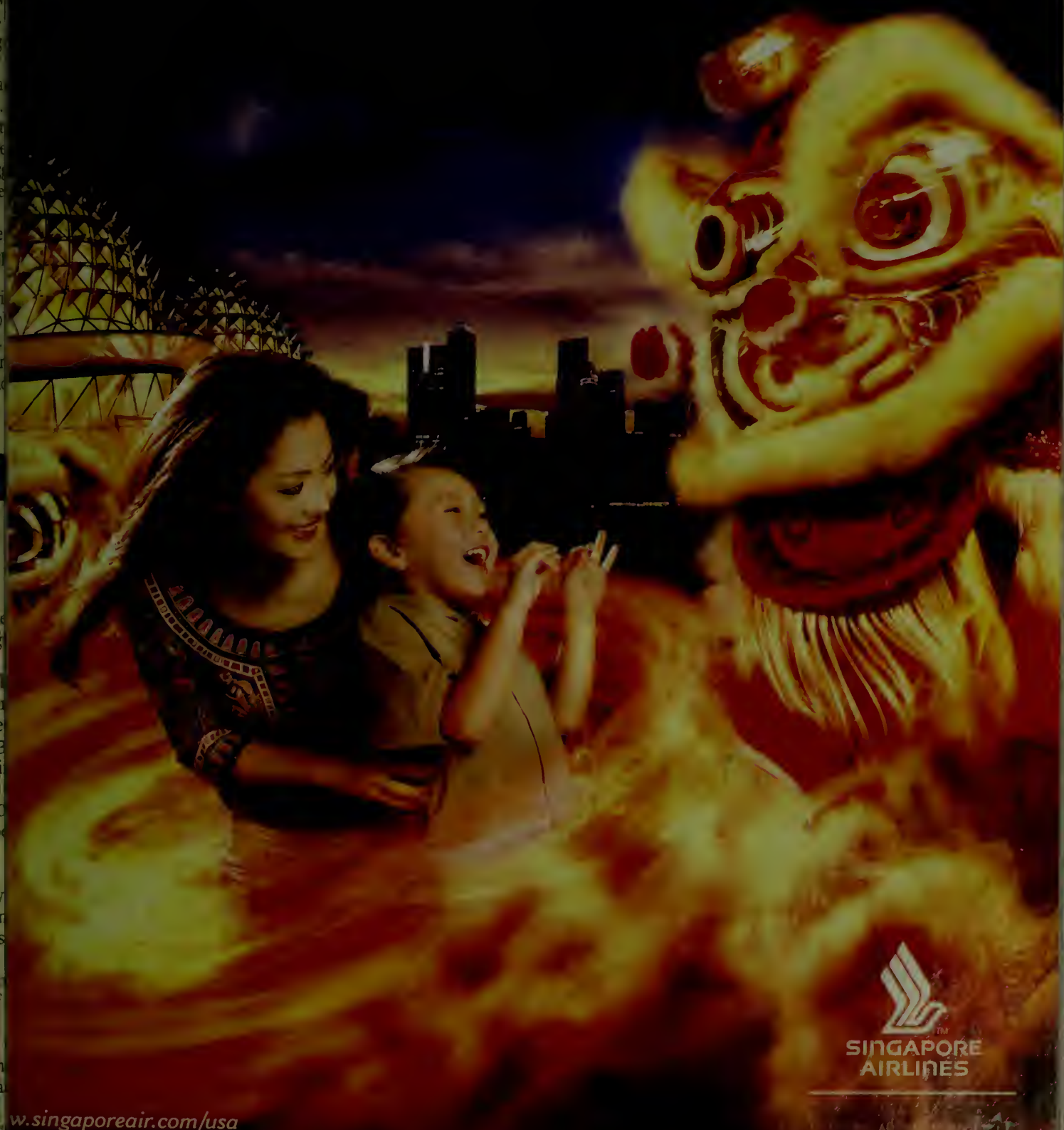
In 2005, export growth is expected to ease up as a result of slower growth in most major global economies. This will be partially offset by an expected rise in domestic demand, so real GDP growth is expected to be about 4% again in 2005. But private and government economists think the rate could be higher if security conditions continue to improve. One key sign to watch is whether Israelis and Palestinians return to the negotiating table after the Jan. 9 Palestinian elections.

—By Neal Sandler in Jerusalem

THE ISRAELI ECONOMY IS ON THE MEND



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DEALMAKING

SHAKE, RATTLE, AND MERGE

Companies with cash. Investors who welcome bold offers. A weak dollar. It looks like a year of big deals

REMEMBER THE URGE to merge? Quelled since 2000, it's coming back. In the last quarter of 2004, deals for U.S. companies came at a trillion-dollar-a-year pace—and more are in store. Companies are looking to mergers again to cut costs, boost efficiency, and extend their reach.

Although mergers dropped off starting in 2001—a victim of recession, corporate scandals, and a sluggish stock market—the animal spirits have returned. The past month alone saw deals for Sprint to combine with Nextel for \$39 billion, Johnson & Johnson to pay \$25 billion for device maker Guidant, and Exelon to acquire Public Service Enterprise Group for \$12 billion. And on Dec. 28, Blockbuster

Inc., backed by financier Carl Icahn, threatened a hostile tender offer for No. 2 video-rental chain Hollywood Entertainment Corp.

DEAL GREASE

BEHIND THE COMEBACK: A robust economy and soaring corporate profits have boosted stock prices and cash. In other words, there's plenty of "deal grease" around. Other factors are at play, too. The weak dollar makes U.S. assets more inviting to foreigners. Stricter governance standards are forcing poorly performing CEOs and boards to entertain unwanted offers. And in a repeat of the 1990s, deals are spawning more deals as companies scramble to keep up in consolidating industries. While it's a good bet that at least some acquirers will overpay or

make bad choices, few are holding b

Little wonder that the rumor is spinning. There's talk SBC Communications could buy BellSouth, uniting two giant Baby Bells; that a Chinese oil company like Sinopec might buy a U.S. outfit like Unocal; or that U.S. Steel be acquired by an Asian or European. action could be fastest in cash-rich sectors such as tech, pharmaceuticals, and banking, says Jason Trennert, an analyst at International Strategy & Investment consulting firm.

Clearly, the rush is already on. There were \$250 billion worth of mergers including assumed debt, in the last 12 months of 2004. That brought the year total to \$809 billion, according to Thomson Financial. While a far cry from the pace through 2000, when annual deal vol

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News Analysis & Commentary

averaged \$1.6 trillion, volume is up 49% over 2003. Execs at Lehman Brothers Inc. and Bank of America Corp. are prepping for a further 15% to 20% increase in 2005.

Partly driving the trend is deal psychology. One big merger in an industry tends to trigger more as companies scramble to stay a part of the pack. In steel, for example, "everybody's in play these days" in the wake of Mittal Steel Co.'s planned purchase of U.S.-based International Steel Group, says Karlis M. Kirsis, managing partner of World Steel Dynamics Inc., an information service in Englewood Cliffs, N.J. Even as U.S. Steel makes bids of its own, analysts say South Korea's Posco or Belgium's Arcelor might snap it up.

Consolidation is also on the table in utilities after Chicago-based Exelon Corp.'s Dec. 20 deal for Newark-based PSEG. "I think some of our colleagues will see this as a catalyst to make some negotiations come to fruition," says John W. Rowe, Exelon's chairman and CEO.

TELECOM TURMOIL

NOWHERE IS THE urge to merge greater than in the once-fragmented telecom industry. In 2004, Cingular Wireless vaulted to No. 1 by buying AT&T Wireless Communications. Then Sprint agreed to buy Nextel to form a stronger No. 3. SBC Communications Inc. wants full ownership of Cingular, but BellSouth isn't selling its 40%. So would SBC simply buy all of BellSouth? Says SBC COO Randall Stephenson: "I don't want to speculate, but who knows? This industry is going to continue to consolidate."

In financial services, too, big is beautiful. Bankers speculate that Citigroup, JP Morgan Chase, and Bank of America will

keep shopping. Many also think someone, perhaps HSBC Holdings PLC, may make a run at Bear Stearns Cos. The brokerage says it doesn't comment on market speculation. HSBC has said in the past it prefers to build up its own investment banking franchise.



“This is going to be a big boys’ game. They’re going to move very aggressively and quickly.”

—Joseph M. Tucci
President and CEO, EMC

In software, the motive for merger is to offer customers a fuller portfolio of products. So niche players are selling out to serial buyers—like Oracle Corp., which snagged PeopleSoft Inc. after a long struggle, and security-software company Symantec Corp., which agreed in December to buy storage-software company Veritas Software Corp. for \$13.5 billion.

Those deals raise questions about whether such Silicon Valley stalwarts as McAfee, BEA Systems, and Siebel Systems are big enough to survive on their own. "This is going to be a big boys' game. They're going to move very aggressively and quickly," says Joseph M. Tucci, president and CEO of data-storage giant EMC Corp., which recently announced a \$260 million cash deal for SMARTS Inc., a network-management software company (page 60). "The fast-moving, well-capitalized companies are going to be the winners in this round."

There's plenty of money for deals. The Standard & Poor's 500-stock index companies, including financial companies, have a record \$2 trillion in cash and other short-term assets, according to S&P Compustat. Close to 60% of the U.S. debt in 2004 were paid for with cash, around 35% in 2000, estimates Stefan

Selig, vice-chairman of Banc of America Securities, the investment banking arm of Banc of America Corp.

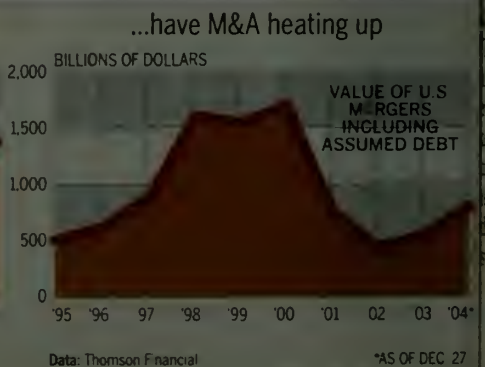
Not all the cash is coming from corporate coffers, though. Hedge funds, which traditionally focused on short-term speculation, are getting into the game. Buyout shops are preparing to work about \$100 billion that was raised in the late 1990s. And private

investment funds such as Edward S. Lampert's \$9 billion ESL Investments Inc. are picking up marquee companies. In November, Kmart Holding Corp., which is 53% owned by ESL, said it would buy Sears, Roebuck & Co. for \$11 billion.

With so much money to deploy, "so many private equity guys are falling... all of themselves to get deals done," says Robert A. Profusek, a senior partner at law firm Jones Day who advised Nextel Communications Inc. on its Sprint deal. "That could be where the action really is next year."

Not only are there tons of cash floating around, but the recent fall of the dollar makes U.S. assets look cheap for foreign investors. A Russian firm, Severstal, already has taken over a bankrupt U.S. steelmaker and is bidding for Canadian Stelco Inc., a big U.S. auto supplier. In banking, London-based HSBC Group and the Royal Bank of Scotland are seen

DEALMAKING STAGES A COMEBACK



adders. "We'll probably see more cross-border deals," says Wilbur L. Ross Jr., chairman and CEO of WL Ross Co., a New York private investment bank. But the fit has to make sense. In Germany, potential buyers are still haunted by the poor results of Jürgen E. Schrempp's hasty merger of Daimler-Benz with Chrysler Corp.

ACTIVE BOARDS

THE SHAREHOLDER rights movement, ignited by executive-suite scandals, also contributes to the rebound in M&A. Institutional Shareholder Services Inc. says that 66 companies repealed their staggered boards in 2004, and 25 eliminated poison pills. "What's happening is a reversal of all the work that started in the '70s, when companies adopted dark repellent and poison pills," says Michael E. Tennenbaum, senior managing partner of Tennenbaum Capital Partners, a private investment firm.

What's more, the legal environment for mergers has rarely been friendlier. Jeffrey N. Gordon, a Columbia University law professor, says the Oracle-Peple trial in Delaware Chancery Court has unnerved corporate directors by making it clear that they could be forced to explain on the stand why poison pills and other defenses are good for shareholders. Also, judges in the Oracle case and in Arch Coal Inc.'s purchase of rival Arch Coal disregarded as irrelevant the testimony from customers worried about postmerger price increases. That back could rob trustbusters at the Justice Dept. and Federal Trade Commission of a crucial weapon in future cases.

Some investment bankers say the new deals will fare better than past ones because acquirers are paying smaller premiums. Managers and boards, under closer scrutiny, are less likely to overpay, says Jack Levy, co-chairman of mergers and acquisitions at Goldman, Sachs & Co.

What's more, adds BofA's Selig, "people are quite chary about getting out of their areas of expertise" in the wake of late-'90s deals that flamed out. Then again, that's the reassuring part: that people always say early in a merger boom. As M&A gets going, however premiums could rise as vows of moderation get thrown to the wind. Still, whether the merger surge ends well or not, there's little doubt that it will be a good year 2005. ■

—By Peter Coy and Emily Thornton in New York, with Michael Arndt in Chicago, Brian Grow in Atlanta, and Andrew Park



TOO QUIET WaMu is shedding profits—and jobs

FINANCE

THE MORTGAGE BIZ HAS LOST ITS FIZZ

Goodbye, refi boom. Hello, sinking profits and industry consolidation

WHEN H&R BLOCK Inc. decided to expand into the mortgage business in the late 1990s, Chief Executive Mark A. Ernst made a big bet that the move would help bolster profits during the lean months between tax seasons. And for years the move paid off. In the fiscal year ended last April, for example, the mortgage division delivered fully 58% of Block's operating income.

But like many financial execs, Ernst is suddenly finding out that the mortgage business isn't what it used to be. With the refi boom largely over since April, earnings are tumbling. Despite a 2.7% rise in mortgage originations for the quarter ended Oct. 31, Block said that its mortgage profits plunged 42%, to \$106 million—pushing it back into the red in its fiscal second quarter.

Moreover, analysts expect Block's profits to slide an additional 19% for the quarter that ends Jan. 31. Competitors "are just pricing loans much tighter than what we would have anticipated," Ernst told Wall Street analysts.

Block's woes are symptomatic of the problems sweeping the mortgage business. With activity slumping and the industry still awash in overcapacity, an intense pricing war has broken out, squeezing profits throughout the industry.

The slump has led to a price war—further squeezing margins

The fierce pressures are setting the stage for a new round of consolidation in the coming year. Many analysts figure marginal lenders will attempt to cut their losses and sell—particularly if the Federal Reserve's campaign to raise interest rates boosts mortgage rates high enough to take the remaining steam out of the housing market. As if that weren't enough, the industry's problems could be compounded by the ac-

counting woes of mortgage giant Fannie Mae, which will be forced to bolster its capital reserves in the wake of accounting restatements that could wipe out \$9 billion of prior earnings going back to 2001.

FANNIE EFFECT

THE ROOTS of the industry's problems are no mystery. Mortgage activity has fallen off sharply since the Fed began hiking rates last spring. From a peak of \$1.2 trillion in the third quarter of 2003, mortgage lending slumped to nearly half that amount in the same quarter of 2004. For the full year, mortgage lending looks set to drop 26%, to \$2.8 trillion. It's expected to dip an additional 17% in 2005. The culprit: the huge slide in refs. For the third quarter, refs plunged 72%, to just \$226 billion—a drop that overshadowed the healthy 20% rise in mortgages used to purchase new and used homes in the same stretch.

BOOMING But what if Fannie scales back mortgage purchases?

Those pressures could get even worse in the coming year. With Fannie Mae facing the prospect of raising between \$3 billion and \$13 billion in fresh capital to satisfy its regulators at the Office of Federal Housing Enterprise Oversight, some analysts fear that it could be forced to sharply scale back its purchases of mortgages from banks and other primary lenders. A sudden drop in purchases by Fannie, in turn, could add to the upward move in mortgage rates that is already being driven by Fed rate hikes. And that could threaten the continued boom in sales of new and used homes. The regulatory pressure on Fannie “could have a significant effect on the mortgage market,” says Arthur Frank, director of mortgage-backed securities research for Nomura Securities International Inc.

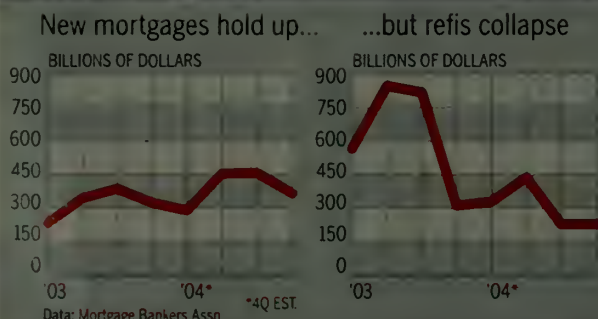
Already, some firms have begun downsizing to adjust to the end of the refi boom: Washington Mutual Inc., for instance, which has so far shed almost 9,000 of its 26,000 mortgage-related jobs over the past year, is trimming the number of full-time workers by an additional 1,800 to 2,000 in the current quarter. And across the country, scores of mortgage brokers have begun putting out the “for sale” sign in hopes of

getting bought out by a larger lender. “Some small banks and mortgage brokers are bailing out of the mortgage business altogether,” notes Bert Ely, an Alexandria (Va.) banking consultant.

LIBERAL STANDARDS

FOR THE MOST PART, though, many of the large players that have built up massive infrastructures for processing loans are pushing ahead full throttle. “There has been no falloff in [lending] capacity,” notes Keith T. Gumbinger, a vice-president at HSH Associates, a Pompton Plains (N.J.) mortgage research firm.

GETTING SQUEEZED



“Right now there’s a game of chicken going on in the industry.”

The result has been a fierce price war as lenders fight for the remaining business: According to HSH Associates, the average rate lenders are charging for a

30-year fixed mortgage has fallen from plump two points over the yield in year Treasuries at this time last year for skimpier 1.6-point premium. While the price war has been a boon for borrowers—helping to keep the average year fixed-rate mortgage down around 5.69%—it’s coming at a time when lender profits are already being squeezed by falling demand. Washington Mutual, which bulked up heavily in mortgage lending in recent years, reported a 34% decline in third-quarter profits on falling volume, while Countrywide Financial Corp., the nation’s largest mortgage lender, saw profits fall 47%.

To keep their loan pipelines full, mortgage lenders are diversifying their product lines. One hot seller: home equity lines of credit. And some are pushing the envelope to qualify as many would-be borrowers as possible with so-called “Alt A” loans that require minimal income documentation. While lenders insist that these new loans will perform fine, some analysts fear defaults could rise as a result of more liberal lending standards. “It’s going to be hitting the fan about a year from now,” says George R. Yacik, a vice-president at SMR Research Corp., a Hackettstown (N.J.) mortgage research firm.

Thinner profits, growing defaults. It’s enough to make lenders pine for the good old days of last spring. ■

—By Dean Foust in Atlanta



BY AMY BARRETT

Pfizer Has Plenty of Pain to Kill

Celebrex is only one of many problems curbing the drugmaker's growth

PFIZER INC.'S management has long been known for taking calculated risks. And its handling of the painkiller Celebrex has been no different. While analysts believe the drug is essentially dead after a study linked it to increased risk of heart attack, Pfizer is hanging tough. Chairman and Chief Executive Henry A. McKinnell says there's conflicting data on

whether Celebrex really poses a risk and insists he has no plans to withdraw it. A risky move, indeed: If another study confirms Celebrex is linked to heart attacks, trial lawyers may have ammunition to argue that Pfizer continued to peddle a dangerous product.

Pfizer's brand of iron will has served the company well over years. But even if its aggressive defense of Celebrex pays off, Pfizer may be on the wrong side of an even bigger gamble. McKinnell & Co. continue to bet that the \$51 billion drug giant's long-term growth prospects are robust. But the challenges facing Pfizer are numerous, most notably weak in-house research and looming threats from generics. As they confront a less prosperous future, management may have to rethink its strategy.

Indeed, more and more investors and analysts argue that the drug company should continue to plow money into new drug development, the company needs to aggressively re-evaluate marketing and other costs and return greater amounts of cash to shareholders through a higher dividend. "They [Pfizer executives] are growth-minded managers in charge of a mature company," argues Sanford C. Bernstein & Co. analyst Richard T. Evans.

The market seems to agree. Four years ago, high-flying stock sported a price-earnings ratio of about 34. Now, Pfizer's valuation has sunk to just 12 times expected 2005 earnings, well below the market multiple of 16.4.

McKinnell acknowledges that the company will see sluggish growth between 2005 and 2007 as products now generating \$14 billion in sales face possible generic competition. He says, however, that in the five-year period ending in 2006 the company will have

CEO MCKINNELL
He insists Pfizer has a robust future



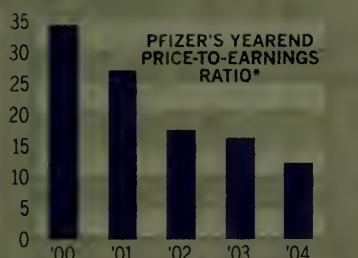
filed for approval on 20 new products—drugs that will help Pfizer generate healthy growth after 2007. That scenario, however, may be overly optimistic. For one thing, even if Celebrex and the painkiller Bextra remain on the market, sales—which currently stand at a combined \$4 billion a year—are likely to decline substantially amid concerns about side effects. At the same time, Pfizer could lose its hold on a crucial market. Indian generic maker Ranbaxy Laboratories Ltd. is fighting Pfizer in a Delaware court for the right to launch a generic version of Lipitor, a cholesterol-lowering drug with \$10 billion in annual sales. Two Lipitor patents are at issue, and Ranbaxy's complex arguments include assertions that the Indian company doesn't infringe the first patent and that the second is invalid. McKinnell says it will be tough for Ranbaxy to win on both patent challenges and that he's confident Pfizer will prevail. But he acknowledges that a loss would be "catastrophic." Smith Barney analyst George Grofik warns, moreover, that Wall Street is underestimating the strength of Ranbaxy's case and that it is far from certain Pfizer will win. If Ranbaxy comes out on top, a generic Lipitor could hit the market in a couple of years, well ahead of the 2011 time frame that the market is anticipating.

There are also questions about the most important drug in Pfizer's pipeline. It is a treatment that raises HDL, or so-called good cholesterol, that Pfizer is combining in one pill with Lipitor. Problem is, it may take years before trials show whether raising HDL actually reduces heart attack deaths. If that data isn't available when the drug launches as expected in 2008, insurance providers may initially resist covering the product.

And even if the combo is a monumental success, it is likely to simply replace Lipitor sales that will eventually be lost to generics. Another reason investors question McKinnell's insistence that Pfizer has plenty of growth ahead. ■

—With Susan Zegel in New York

A GROWTH STOCK NO MORE



*SHARE PRICE DIVIDED BY ESTIMATED EARNINGS PER SHARE FOR THE FOLLOWING YEAR

Data: Thomson First Call

COMMENTARY

BY LOUISE LEE

What's Roiling the Selling Season

Retailers' tactics, like pushing gift cards, are changing the business for good

IF RETAILERS LEARNED ANYTHING during the 2004 holiday shopping season, it was that the rules of engagement have changed drastically. And those changes are largely of their own making. In an all-out effort to goose sales with discounts, gift cards, and other blandishments, retailers have helped alter consumer behavior so much that many are now scrambling to catch up.

By now, everyone knows Americans expect big discounts—despite retailers' annual vows to limit them. This year was no different; shoppers rushed to the stores in the week before Christmas when stores finally piled on with their biggest sales. But the gift card phenomenon is adding a new wrinkle this season. Analyst Kristine Koerber of JMP Securities estimates that cards accounted for 10% of sales, up from 7% to 8% in 2003. That means plenty of "Christmas" purchases won't take place until January, when many cards are redeemed.

All that makes it harder to judge how well retailers are doing. On Dec. 26, MasterCard International estimated that holiday retail sales would rise by 8.1% over '03; other estimates ranged from 3.2% to 4.5%, about level or slightly below 2003. The difference partly reflects the fact that MasterCard includes gift card sales in its tally; others don't count the cards until they're used.

What does all this mean for retailers? With the holiday season now stretching well into January, and discounts here to stay, they'll have to get a lot smarter about who their customers are, what they put on the shelves, and how to get folks to buy full-price. Here's how some stores are adapting:

MAKE GIFT CARDS PAY. Gift-card redeemers tend to be free spenders. Shoppers with cards often buy full-priced goods when presented with them, generating more profit for a store

than the sale of, say, two sweaters at 50% off. So smart retailers are moving to make sure they have plenty of full-price merchandise on hand when these folks show up—stocking fresh products in late December and early January, rather than waiting until February. Over the past couple of years, Charm Shoppes Inc.'s Lane Bryant chain has begun displaying full-priced spring clothes in December. Now, thanks to the popularity of gift cards, sales of those clothes are taking off. The same goes for other retailers as disparate as Coach, Ann Taylor, and American Eagle Outfitters all had new apparel ready to sell, notes NPD Group analyst Marshall Cohen. "This is a way to not only clear leftovers but to sell higher-margin stuff," he says.

GO LOCAL. It's no longer enough for a retailer to profile customers nationwide, or even by region. To avoid discounting

many also will need to tailor stock to local conditions. That's one of the secrets behind the success of F. B. Buy Co., which is expected to post far stronger sales than chief rival Circuit City for the '04 season. The electronics chain determines if local customers tend to fall into key categories, including "busy suburban mom" and "affluent professional." Stores serving the wealthy bulk on home-theater gear, while those with a lot of mothers in the 'hood talk up the convenience of digital cameras for photographing kids.



GOING TWICE
A N.Y. store
relies on
holiday sales

Tailoring chain products to local tastes is one way to lift margins

seems to work: Best Buy says stores that have gone local boost higher gross margins and same-store sales growth that's twice as fast as the rest of the chain.

INCLUDE THE EXCLUSIVE. Increasingly, rival retailers are taking a page from Target Corp. and Kmart Corp., which for years have managed to stand out from the crowd—and boost gross margins—by selling exclusive lines created by the likes of Michael Graves and Martha Stewart. J.C. Penney Co. now sells home wares designed by celebrity wedding planner Colin Cowie. I. Bath & Beyond Inc. carries an exclusive line of textiles created by dress designer Nicole Miller. So far, however, no retailer has managed to duplicate Target's or Kmart's success. That's because carrying an exclusive brand requires more than slapping a name on a few pieces of merchandise. Retailers need large, comprehensive lines to create a strong visual impact in store and generate substantial sales. "If you're going to create your own brand," says New York marketing consultant Wendy Liemann, "you have to build it and market it." Clearly, minding the store has never been more complicated. ■

—With David Kiley in New York



HARVESTING HOPE
A congressional
showdown is
looming

IMMIGRATION

MI CASA ES SU CASA? GET REAL

The GOP ranks are bristling at the president's agenda on illegal aliens

AS HOME TO THOUSANDS of Mormons who have spent time on religious missions, Utah looks more kindly on immigrants than does most of the U.S. It's one of only four states that offer illegal aliens with drivers' licenses and in-state tuition at public colleges. But Phyllis Sears, a retired engineer and Republican Party official, aims to haul in the welcome mat. As chair of a newly formed local Citizens Council on Illegal Immigration, Sears wants Utah's construction companies, hotels, and restaurants to publicly pledge not to hire illegals so locals can support American outfits and avoid those that won't sign. "Some businesses are profiting from hiring illegals, while citizens have to pay higher taxes for schools and government services," says Sears. GOP activists such as Sears spell trouble for George W. Bush. As the President appeals to Hispanic voters with Cabinet appointments, political appeals, and immigrant-friendly policies, a rebellion is bub-

bling up through his party's ranks. The reason: The influx of illegals is hitting such solidly red states as Arizona and Utah particularly hard. "The problem seems to get more attention during times of fiscal distress for the states," says Jeffrey S. Passel, who studies immigration at the Urban Institute in Washington.

Look for the clash to intensify in late January. Although the issue got put on the back burner in the wake of September 11, the President plans to push once more for partial amnesty and a guest-worker program for illegal immigrants. But that call will run smack into rank-and-file Republican pressure to crack down on illegals. Hard-liners intend to introduce a bill early in the new Congress making it more difficult for immigrants to sneak in, claim asylum, and obtain documents to work in the underground economy.

To get the intelligence overhaul bill passed in December, the White House agreed not to try to block debate on the tighter controls when Congress reconvenes in January. But White House political guru Karl Rove says Bush is more determined than ever to see a guest-worker program enacted. Under the plan, illegals could apply for a three-year, renewable green card as long as they can show that they've ponied up payroll taxes and stayed out of trouble with the law. The Census Bureau estimates that there are 10 million illegals in the U.S.; of that number, perhaps 40% will be eligible for green cards.

SHIFTING CLIMATE

THE INTRAPARTY CROSSFIRE has Corporate America worried. The agriculture, hotel, and restaurant industries rely on low-wage immigrants—many of them illegals who evade hiring controls. "There are probably 6 million or more [undocumented workers] who are raising children and paying taxes and are the backbone of some industries," says Sandra Boyd, a vice-president at the National Association of Manufacturers. "It's ridiculous to think we would deport them all."

Conservative Republicans say they're responding to public anger over the growing burden illegals are putting on public services, including health care. "The political climate is shifting on this," says Roy Beck, head of NumbersUSA, which seeks immigration curbs. The latest evidence: Arizona's Proposition 200, which prohibits illegal aliens from getting government benefits and requires state employees to report them to law enforcement or face jail time.

A plan modeled on the Bush initiative will be introduced in January by Senator John McCain (R-Ariz.). The bill would make illegal workers' quest for legitimacy even easier by encouraging them to return home and apply for guest-worker status. McCain's aides say his bill will also provide illegals a path to citizenship—something Bush omitted.

When the two conflicting GOP bills arrive in Congress, "it will be like a perfect storm," says Representative Tom Tancredo (R-Colo.), who favors stricter enforcement of employer sanctions for hiring illegal aliens. So far, neither side can figure out how to stop it. ■

—By Paul Magnusson in Washington

THE STAT

10
MILLION

Estimated number of illegal immigrants, 40% of whom could qualify for amnesty

Data: BusinessWeek, U.S. Census Bureau

THE INTERNET

ONLINE VIDEO: THE SEQUEL

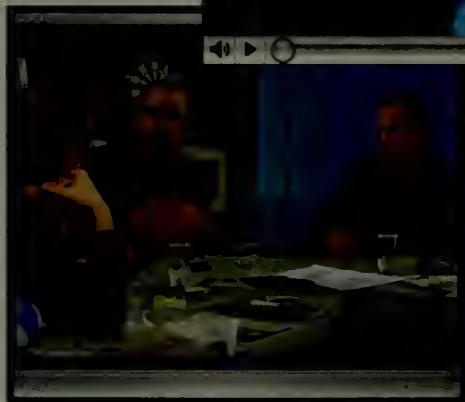
Video blogs are proliferating, and mainstream companies are taking notice

RYAN HODSON OPENS HER videos with a close-up of herself. Wearing no make-up and speaking in a deadpan, she narrates two- to five-minute films that creep in and out of the absurd. In one she tours her house, filming the trash flung in the corner of the bedroom her roommate seldom leaves.

Hodson, an editor at WGBH, Boston's PBS station, toyed with developing a show for mainstream TV. In the end she joined a growing throng who meld blogs with videos. "I have bizarre ideas that might be hard to get on TV," says Hodson, 25. "Now I'm seeing people respond to them every day."

Welcome to the latest Net phenomenon: video blogs, or what some folks call vlogs. Thousands of ordinary (and some downright nutty) people have begun posting a cornucopia of video fare online, from self-indulgent art clips and earnest citizen journalism to sly political commentary. Experimentation is the rule, and eccentrics outnumber serious practitioners. But amid the chaos, glimpses of a commercial future are starting to emerge, including a revival of online video distribution, using vlogs to sell ads, and corporate sites designed to reach out to customers and suppliers. "Text doesn't get across all I want to communicate," says Lenn Pryor, who runs Channel 9, a vlog that Microsoft Corp. set up in April to communicate more effectively with software developers.

Online video had a brief heyday during the late '90s, when the likes of Pop.com and Digital Entertainment Network start-



VLOG WILD
(top to bottom): Ryan Hodson, an online confab on Microsoft's Channel 9, and animation from indie site AtomFilms

liferation of high-speed broadband, new pioneers are emerging. "Video on the Internet has been there for a while," says Steve Rubel, whose blog, Micro Persuasion, talks about publishing trends. "What vlogging is doing is making it easier to share and find."

That development is due in large part to the spread of better distribution technology. Broadband is now in more than 40% of

online U.S. households, meaning roughly 31 million people can now stream video easily. Another boost has come from the widespread adoption of blogging software known as really simple syndication, or RSS, which lets people customize content. With RSS, users can choose the types of video they want to see and have it sent automatically to their PCs. At the same time, cheaper digital video gear and better copyright protection is convincing more folks to put their work online.

LOG AND LOAD

THE VLOG PHENOMENON has stirred a wave of creativity at grassroots groups and companies alike. Online video sites such as Undergroundfilm, are adding blogging sections. Ourmedia, an online showcase for digital content, is expected to launch early this month. It will provide free storage and blogging room for creative types such as New York indie musician Sam Bisbee, whose music video will be available for free. "You see video bubbling up all over the Web," says J.D. LaRocca, who runs Ourmedia. "My thought was to gather it all in one place."

The proliferation of video is prompting commercial entities to take a second look. On Dec. 16, Yahoo! Inc. launched an online search service that uses RSS tools developed with Ourmedia and an indie site AtomFilms.

collect videos from around the Web. Blogs that sell ads, such as consumer-electronics new site Engadget, are adding video product reviews. And Microsoft's Channel 9, which attracts 900,000 viewers a month, dishes up interviews and demos to stay in close contact with

key software-developer community.

For some indie filmmakers who weathered the video drought online, the Internet is finally starting to live up to its early promise. Peter John Ross posted short films on a handful of online video sites before they imploded in 2000. But he kept plugging away, using his own site and other survivors to promote his videos. "It's amazing how people will find your work," says Ross. The right kind of people, too: Ross recently got financial backing for his first full-length film. ■

—By Heather Green in New York

BusinessWeek online For more about the evolution of blogging, go to www.businessweek.com/extras



moving forward ▶

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with an expiration date.*



SEQUOIA *They grow up fast.* Make sure your memories last a lifetime. Take family time further in the 282-hp 8-passenger Sequoia. Now with a set of five standard safety features called the Star Safety System,[™] available exclusively from Toyota. toyota.com



Vehicles shown with available equipment. ©2004 Toyota Motor Sales, U.S.A., Inc.

MEDIA

CAN MURDOCH OUTFOX CNBC?

With a Fox business channel likely to launch, a cable brawl is ready to begin

ON DEC. 15, THE TIME Warner cable channel CNNfn aired its final programs after years of languishing behind CNBC's business news fare. Not that CNBC doesn't have problems of its own. Its ratings have plummeted since the Internet boom went bust. And CNBC's ever-changing prime-time schedule never seems to click with viewers. Bringing financial news to TV is no sure bet.

So why does News Corp. Chairman Rupert Murdoch think he can muscle into financial TV news? Murdoch has said Fox will launch an all-business news channel in the summer of 2005. But even though his Fox News startup has eclipsed stalwart CNN in the ratings battle recently, it seems an odd time to dive into the troubled financial TV news segment.

ACE IN THE HOLE

WHERE OTHERS SEE risk, though, Murdoch sees a pot of money. While CNBC's ratings are down, the channel's relatively low-cost programming allows it to generate lots of cash for parent GE. It also gets a more-than-10% premium over what other cable networks charge advertisers, thanks to its high-net-worth audience of business execs and Wall Streeters. No doubt, Murdoch believes he can take some of that windfall away from CNBC. What's more, he's holding a clear ace: Roger Ailes, one of the architects of CNBC, moved over to head Fox News in 1995. Ailes is legendary within the industry for his ability to figure out what keeps mainstream America glued to the tube and, thanks to his CNBC background, he possesses an insider's knowledge of the competition.

So what's the likely plan of attack? Fox execs aren't talking, but industry insiders



Getting Down To Business

Why Fox sees opportunity in financial news

PRIME TIME CNBC is no longer running business shows at night, creating an opening if the programming is right

FOX POPULI Fox could lure mainstream viewers with gossipy news, replicating the easy read of the *New York Post's* business section, another News Corp. property

KA-CHING Advertisers sometimes pay more than a 10% premium for spots on CNBC's shows versus prime time on other cable channels. Fox wants a piece of that action

bet Murdoch and Ailes will differentiate Fox from CNBC by gearing Fox's fare less to high-end Wall Streeters and more to average folks. They're also apt to jazz up programs and generate buzz. That could include using the business page of Murdoch's own *New York Post* as a prototype. The tabloid often breaks news and a gossipy, lively read. If that experience can be translated to TV, "it could succeed, too," says Tom Rogers, chairman of TiVo and the NBC executive who oversaw the launch of CNBC in 1989.

Another strategy would be to hit CNBC where it's weakest—prime time. The channel has dropped business shows at night and is still struggling for the right formula, even slotting reruns of Conan O'Brien.

TOP TALENT Neil Cavuto's show gives Fox a leg up

Fox already has a string of strong shows to slot with if it decides to migrate an existing program

from its general news channel to the business channel. Ailes has claimed the highest-rated business programs on cable are already produced by Fox News, and its top business anchor Neil Cavuto, a CNBC alum. It's not yet known whether popular shows like *Cavuto on Business*, *Cashin' In*, *Bulls and Bears*, and *Forbes* Fox will migrate to the new channel. Either way, Fox has proved its ability to draw an audience.

CNBC execs say they're not worried about Murdoch. They insist CNBC, which generates an estimated \$100 million a year in cash flow, owes its success to a core audience of elite viewers, including many CEOs who have the channel on in their offices. CNBC Chief Executive Pamela Thomas-Graham says advertisers have responded to those viewers by paying higher rates for spots on the channel.

An early test will be whether Fox can secure broad distribution. CNNfn's failure to do so helped speed its demise: It was only 30 million homes, vs. CNBC's 86 million homes and offices. Without that reach, it's hard to build the audience strong ad sales. But Murdoch has claimed he can use News Corp.'s 13.5 million DirecTV subscribers as leverage with cable outfits such as Comcast Corp. Time Warner, since they'd like satellite distribution for their own programs.

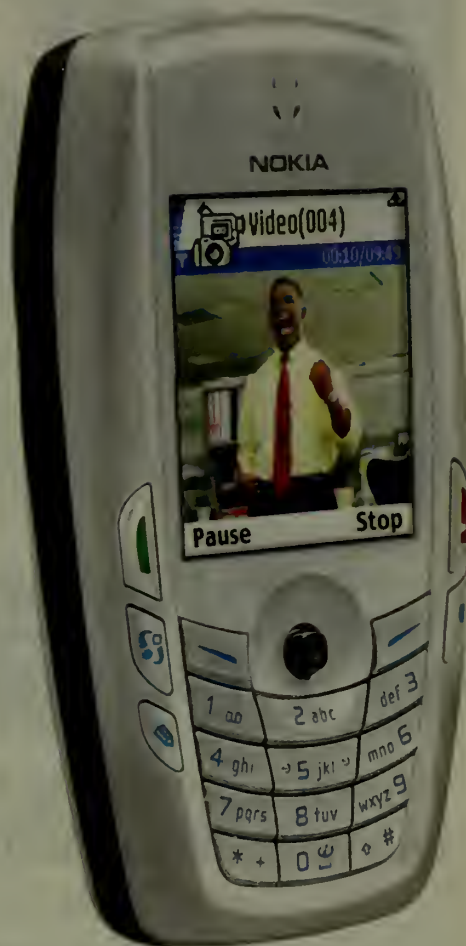
So is there room on TV for another business channel? "If you look at the ample of CNNfn, you may have the answer to that question," says Thomas-Graham. But as one TV executive says: "Rupert doesn't get into the game to be No. 1. No. 3." Let the ratings war begin. ■

—By Tom Lowry in New York



Shot at 2:34

Shared at 2:35



Your life with instant replay. **Shared instantly.**

Not a basket. Shoot a
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phone... a perfect way to
capture and share life's
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ACCOUNTING

GREEN EYESHADES NEVER LOOKED SO SEXY

Raises, perks, long sabbaticals—auditors can write their own ticket these days

THREE YEARS AFTER accounting scandals roiled Enron Corp., audit firms are still regularly making headlines for all the wrong reasons. In the past week alone, KPMG was dismissed from its audit duties at troubled mortgage company Fannie Mae, while Ernst & Young agreed to pay a \$125 million fine arising from its role in auditing Superior Bank, a failed Illinois thrift. KPMG says its work for Fannie was “grounded in the principles” of proper accounting, while E&Y maintains it is not liable for Superior’s problems.

Yet there has never been a better time to be an auditor. Thanks to congressional demands for more extensive probes, companies and their outside auditors are adding accountants at a record pace. Even the federal government, from the Securities & Exchange Commission to the FBI, is hiring. “We have 1,200 more people today than a year ago, and if we could have another 1,000 people tomorrow, we’d take them,” says Allen Thomas, national managing director

for human resources for Deloitte & Touche.

The crunch stems largely from auditing reforms passed by Congress in the wake of Enron and other scandals. Those changes have increased the number of hours it takes to do a typical audit by 40% to 60%. Yet even as demand has spiked, the supply of auditors is down. In the 1990s, numbers-savvy students bypassed accounting degrees in favor of finance and technology programs. By 2001 the number of students earning accounting degrees had dropped below 45,000, from more than 60,000 graduates 10 years earlier. That has creat-

LENGTHY BREAK Deloitte’s Donaghey took a five-year leave

ed a “sellers’ market for talent, says Garrison, head of and assurance for waterhouseCooper.

It’s not just Big Four firms such as that need to staff up. With CEOs and boards of public corporations now requiring a vouch for their numbers, companies are also scrambling for extra auditors. Gr including Ford, Motorola, and Johnson Johnson, have been hiring accountants at a brisk pace, according to university placement officers. Government organizations are also big recruiters. Everyone from the Public Company Accounting Oversight Board, a watchdog agency created by the Sarbanes-Oxley Act, to the FBI, which set a goal that 15% of its new recruits be accountants, is in the market.

QUITE A BONANZA

ALL OF WHICH MAKES for quite a bonanza in perks and workplace flexibility, particularly for the mid- and senior-level managers most in demand. This summer Deloitte launched a program that allows top performers to take a leave for up to five years. The firm continues to pay for career education and licensing, and signs each leave-taker a personal memo to keep them involved and up to date. The program is aimed at keeping the most likely to jump ship—those with enough experience to be attractive to outsiders but who have not yet made partner. Ann Donaghey, 38, had been promoted twice since she joined the firm six years ago, but she was prepared to quit after having twin boys in February. When Donaghey learned she could apply for a year leave, it was a great relief. But it has been an even bigger relief to Deloitte: Replacing Donaghey would have cost roughly double her annual salary.

Compensation is also on the rise. Most firms say auditors’ pay is up 10% to 20% across the board this year. For top performers, 20% is probably more like it. Bonuses are more frequent, too. But big raises and salaries are just part of the package. Ernst & Young, which boosted hiring of experienced accountants by 25% this year and added 23% more college grads, does offer more vacation time as well. It even offers a concierge service for staff to get personal errands done.

The auditing frenzy won’t be forever. Enrollment in accounting classes is climbing, and more students are pursuing a degree. So for now, auditing is a great gig.

—By Nanette Byrnes in New York

In Demand

Audit firms, companies, and even the FBI are scrambling to hire CPAs. Among the lures:

BETTER PAY New recruits can get as much as \$3,000 for coming on board, while salaries and partner pay are up as much as 20% in the last two years

SABBATICALS Deloitte & Touche is offering leaves of up to five years to hold on to experienced CPAs

PERKS GALORE Ernst & Young offers concierge service to its audit staff to help out with errands

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The most common side effects of VIAGRA are headache, facial flushing, and upset stomach. Less common are bluish or blurred vision, or being sensitive to light. These may occur for a brief time. Remember to protect yourself and your partner from sexually transmitted diseases.

Talk with your doctor first. Make sure you are healthy enough to have sex. If you have chest pain, nausea, or other discomforts during sex, seek medical help right away. The same is true if you have an erection that lasts more than 4 hours. Call for help at once.

VIAGRA is covered under most Managed Care Plans.

For some men, in as quickly as 10 minutes; for most, in under a half hour (statistical significance at 14 minutes). In this study, VIAGRA responders, given 100 mg 2 hours after eating, were timed to see how fast they got an erection that enabled them to have sex.

Data on file. Pfizer Inc., New York, NY

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VIAGRA
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PATIENT SUMMARY OF
INFORMATION ABOUT

VIAGRA®

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This medicine can help many men when it is used as prescribed by their doctors. However, VIAGRA is not for everyone. It is intended for use only by men who have a condition called erectile dysfunction. VIAGRA must never be used by men who are taking medicines that contain nitrates of any kind, at any time. This includes nitroglycerin. If you take VIAGRA with any nitrate medicine your blood pressure could suddenly drop to an unsafe or life threatening level.

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You will not get an erection just by taking this medicine. VIAGRA helps a man with erectile dysfunction get an erection only when he is sexually excited.

• **How Sex Affects the Body**

When a man is sexually excited, the penis rapidly fills with more blood than usual. The penis then expands and hardens. This is called an erection. After the man is done having sex, this extra blood flows out of the penis back into the body. The erection goes away. If an erection lasts for a long time (more than 6 hours), it can permanently damage your penis. You should call a doctor immediately if you ever have a prolonged erection that lasts more than 4 hours.

Some conditions and medicines interfere with this natural erection process. The penis cannot fill with enough blood. The man cannot have an erection. This is called erectile dysfunction if it becomes a frequent problem.

During sex, your heart works harder. Therefore sexual activity may not be advisable for people who have heart problems. Before you start any treatment for erectile dysfunction, ask your doctor if your heart is healthy enough to handle the extra strain of having sex. If you have chest pains, dizziness or nausea during sex, stop having sex and immediately tell your doctor you have had this problem.

• **How VIAGRA Works**

VIAGRA enables many men with erectile dysfunction to respond to sexual stimulation. When a man is sexually excited, VIAGRA helps the penis fill with enough blood to cause an erection. After sex is over, the erection goes away.

• **VIAGRA Is Not for Everyone**

As noted above (*How Sex Affects the Body*), ask your doctor if your heart is healthy enough for sexual activity.

If you take any medicines that contain nitrates – either regularly or as needed – you should never take VIAGRA. If you take VIAGRA with any nitrate medicine or recreational drug containing nitrates, your blood pressure could suddenly drop to an unsafe level. You could get dizzy, faint, or even have a heart attack or stroke. Nitrates are found in many prescription medicines that are used to treat angina (chest pain due to heart disease) such as:

- nitroglycerin (sprays, ointments, skin patches or pastes, and tablets that are swallowed or dissolved in the mouth)
- isosorbide mononitrate and isosorbide dinitrate (tablets that are swallowed, chewed, or dissolved in the mouth)

Nitrates are also found in recreational drugs such as amyl nitrate or nitrite ("poppers"). If you are not sure if any of your medicines contain nitrates, or if you do not understand what nitrates are, ask your doctor or pharmacist.

VIAGRA is only for patients with erectile dysfunction. VIAGRA is not for newborns, children, or women. Do not let anyone else take your VIAGRA. VIAGRA must be used only under a doctor's supervision.

• **What VIAGRA Does Not Do**

- VIAGRA does not cure erectile dysfunction. It is a treatment for erectile dysfunction.
- VIAGRA does not protect you or your partner from getting sexually transmitted diseases, including HIV — the virus that causes AIDS.
- VIAGRA is not a hormone or an aphrodisiac.

• **What To Tell Your Doctor Before You Begin VIAGRA**

Only your doctor can decide if VIAGRA is right for you. VIAGRA can cause mild, temporary lowering of your blood pressure. You will need to have a thorough medical exam to diagnose your erectile dysfunction and to find out if you can safely take VIAGRA alone or with your other medicines. Your doctor should determine if your heart is healthy enough to handle the extra strain of having sex.

Be sure to tell your doctor if you:

- have ever had any heart problems (e.g., angina, chest pain, heart failure, irregular heart beats, heart attack or narrowing of the aortic valve)
- have ever had a stroke
- have low or high blood pressure
- have a rare inherited eye disease called retinitis pigmentosa
- have ever had any kidney problems
- have ever had any liver problems
- have ever had any blood problems, including sickle cell anemia or leukemia
- are allergic to sildenafil or any of the other ingredients of VIAGRA tablets
- have a deformed penis, Peyronie's disease, or ever had an erection that lasted more than 4 hours
- have stomach ulcers or any types of bleeding problems
- are taking any other medicines

• **VIAGRA and Other Medicines**

Some medicines can change the way VIAGRA works. Tell your doctor about **any medicines** you are taking. Do not start or stop taking any medicines before checking with your doctor or pharmacist. This includes prescription and nonprescription medicines or remedies:

- Remember, VIAGRA should never be used with medicines that contain nitrates (see *VIAGRA Is Not for Everyone*).
- If you are taking alpha-blocker therapy for the treatment of high blood pressure or prostate problems, you should not take a dose of greater than 25 mg of VIAGRA at the same time (within 4 hours) as you take your dose of alpha-blocker.
- If you are taking a protease inhibitor, your dose may be adjusted (please see *Finding the Right Dose for You*).
- VIAGRA should not be used with any other medical treatments that cause erections. These treatments include pills, medicines that are injected or inserted into the penis, implants or vacuum pumps.

• **Finding the Right Dose for You**

VIAGRA comes in different doses (25 mg, 50 mg and 100 mg). If you do not get the results you expect, talk with your doctor. You and your doctor can determine the dose that works best for you.

- Do not take more VIAGRA than your doctor prescribes.
- If you think you need a larger dose of VIAGRA, check with your doctor.
- VIAGRA should not be taken more than once a day.

If you are older than age 65, or have serious liver or kidney problems, your doctor may start you at the lowest dose (25 mg) of VIAGRA. If you are taking protease inhibitors, such as for the treatment of HIV, your doctor may recommend a 25 mg dose and may limit you to a maximum single dose of 25 mg of VIAGRA in a 48 hour period. If you are taking alpha-blocker therapy, you should not take a dose of greater than 25 mg of VIAGRA at the same time (within 4 hours) as your dose of alpha-blocker.

• **How To Take VIAGRA**

Take VIAGRA about one hour before you plan to have sex. Beginning in about 30 minutes and for up to 4 hours, VIAGRA can help you get an erection if you are sexually excited. If you take VIAGRA after a high-fat meal (such as a cheeseburger and french fries), the medicine may take a little longer to start working. VIAGRA can help you get an erection when you are sexually excited. You will not get an erection just by taking the pill.

• **Possible Side Effects**

Like all medicines, VIAGRA can cause some side effects. These effects are usually mild to moderate and usually don't last longer than a few hours. Some of these side effects are more likely to occur with higher doses. The most common side effects of VIAGRA are headache, flushing of the face, and upset stomach. Less common side effects that may occur are temporary changes in color vision (such as trouble telling the difference between blue and green objects or having a blue color tinge to them), eyes being more sensitive to light, or blurred vision.

In rare instances, men have reported an erection that lasts many hours. You should call a doctor immediately if you ever have an erection that lasts more than 4 hours. If not treated right away, permanent damage to your penis could occur (see *How Sex Affects the Body*).

Heart attack, stroke, irregular heart beats, and death have been reported rarely in men taking VIAGRA. Most, but not all, of these men had heart problems before taking this medicine. It is not possible to determine whether these events were directly related to VIAGRA.

VIAGRA may cause other side effects besides those listed on this sheet. If you want more information or develop any side effects or symptoms you are concerned about, call your doctor.

• **Accidental Overdose**

In case of accidental overdose, call your doctor right away.

• **Storing VIAGRA**

Keep VIAGRA out of the reach of children. Keep VIAGRA in its original container. Store at 25°C (77°F); excursions permitted to 15-30°C (59-86°F) [see USP Controlled Room Temperature].

• **For More Information on VIAGRA**

VIAGRA is a prescription medicine used to treat erectile dysfunction. Only your doctor can decide if it is right for you. This sheet is only a summary. If you have any questions or want more information about VIAGRA, talk with your doctor or pharmacist, visit www.viagra.com, or call 1-888-4VIAGRA.



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September 2002

EDITED BY MONICA GAGNIER

HEADLINER

DANIEL MUDD



FIXING UP FANNIE

Daniel Mudd is no stranger to crisis. As president of GE Capital's Asia-Pacific operation in the late '90s, he guided the lender through the region's financial meltdown.

But nothing tops the challenge Mudd now faces as interim chief executive of Fannie Mae. Promoted from COO on Dec. 21 to replace Chairman and CEO Franklin Raines (pages 13, 75), the 46-year-old Mudd must quell turmoil after the mortgage giant's management shake-up. Also on his to-do list: launch what could be a two-year effort to revise financial statements that overstated profits by \$9 billion and figure out how to raise anywhere from \$3 billion to \$13 billion in capital. And all this must be undertaken as Fannie's regulator pushes for an outsider to assume the CEO role permanently.

Mudd's first day on the job reflected Fannie's new status: He paid a call on the Office of Federal Housing Enterprise Oversight, the regulator that Raines often battled, to pledge his cooperation. For his crisis, humility may be Mudd's best weapon.

—Mike McNamee

FORD TRUCKS POWER UP

Keep on truckin': Ford Motor expects record sales of its full-size F-series pickup trucks for 2004, topping 2001's peak of nearly 912,000. Despite the entry of Japanese rivals Toyota and Nissan into the lucrative segment, Ford's F-150 pickups have kept up brisk sales since their 2003 redesign. The auto maker's larger F-250 and F-350 Super Duty trucks, revamped last summer, are also hits. Big pickups have been a bright spot at Ford, which lost 1.2 points of U.S. market share in 2004. Just as bad, the Ford Div.'s 17-year reign as the top-selling brand in the U.S. may have come to an end. Chevrolet, which has been piling on the rebates, held a 8,600-vehicle lead over its domestic rival in late November. Ford hopes a crop of new models will shore up car sales in 2005.

HOLLYWOOD OR BUST?



Blockbuster threatened to launch a \$1 billion hostile bid for No. 2 video chain Hollywood Entertainment by mid-January. Blockbuster, which says it will bid \$11.50 a share, has been stymied in merger talks for five weeks by Hollywood board members who apparently favor a \$10.25 leveraged buyout offer

from Hollywood CEO Mark Wattles and buyout firm Leonard Green. Blockbuster's merger talks with Hollywood began after financier Carl Icahn took stakes in both companies and urged them to combine. Blockbuster said it might raise its offer higher than \$11.50 if Hollywood cooperates.

A NOT-SO-GRAND TOUR

Microsoft lost its bid to put European sanctions against the company on hold. On Dec. 22, Bo Vesterdorf, the president of the European Court of First Instance, rejected Microsoft's request to delay remedies included in the European Commission's March decision that the software giant had violated European antitrust law. That means that Microsoft will have to share proprietary information about its Windows operating system with the competition while it appeals the decision. It must also offer a version of Windows without its audio and video player. Microsoft had hoped a delay in the remedies would restart settlement talks. Now it must litigate the case.

HILL'S STEEP DESCENT

With the folksy image of his St. Louis firm sullied, Edward Jones & Co. Chief Douglas Hill is calling it quits. Hill will step down as managing general partner at the end of 2005. He'll also pay \$3 million—part of a \$75 million overall settlement by the firm—to resolve enforcement proceedings by the Securities & Exchange Commission, NASD, and the New York Stock Exchange. Regulators alleged that Jones collected millions

each year from mutual funds on top of commissions, pitching these funds to clients as "preferred" without disclosing the extra payments. The firm neither admitted nor denied wrongdoing, though it accepted a formal censure. A spokeswoman for Jones says Hill declined to comment. His lawyer didn't return phone calls.

ET CETERA...

- » Transportation Secretary Norman Mineta ordered an audit of the airline industry.
- » Home Depot will sell large appliances online.
- » Pfizer won approval to sell its medicine Vfend to treat bloodstream infections.

CLOSING BELL

This holiday season, many shoppers decided to click instead of drive. Amazon.com set a new record of 2.8 million items sold on a single day. Investors smelled a post-Christmas bargain, bidding up Amazon's stock 14.6%, to \$44.63, in the two days ended on Dec. 28.



BIOTECH

ASIA IS STEM CELL CENTRAL

Singapore and others are racing to grab the lead in a promising field

HOW DO YOU FOLLOW UP on Dolly the Sheep? For Alan Colman, an English biochemist and a leader of the British team that created the first cloned mammal in 1997, the answer was to abandon the cold moors, heaths, and braes of Scotland for steamy Singapore. But it wasn't the tropical weather that drew Colman. Instead, the 56-year-old scientist chose the city-state because of its tolerant climate for research using embryonic stem cells. Not yet assigned specific roles in the body, these cells are like blank slates that scientists hope can be used to treat many different diseases. But because the cells are taken from human embryos, funding for such research has been restricted in the U.S. since 2001. Singapore, by contrast, is creating "a center of excellence in stem cell research," Colman says, and there's plenty of funding there, too.

That's part of Singapore's effort to build a biotech industry. The government has established a \$600 million fund to invest in startups engaged in research on stem cells and other cutting-edge life-sciences projects. Last year, Singapore opened Biopolis, a 2 million-square-foot complex of laboratories and offices devoted to such research. So far, Singapore has ponied up \$22 million for ES Cell International, the Biopolis-based company

where Colman has worked as chief scientific officer since 2002. ES today owns six stem-cell lines (a line is a group of identical cells that come from the same embryo) and is focusing on developing treatments for diabetes. "Here, there's huge support," says Robert Klupacs, ES Cell's chief executive officer.

"ASTONISHING" PROGRESS

SINGAPORE ISN'T THE only country in the region trying to profit from the U.S. restrictions. Australia, China, India, Japan, and South Korea all see stem cell research as a way to get ahead in biotech. The progress the Asians have made is "astonishing," says Robert A. Goldstein, chief scientific officer at New York-based Juvenile Diabetes Research Foundation International, which has teamed up with

The Asian Alternative

The region is stepping into the breach as federal funding in the United States remains limited.

SINGAPORE Last year opened Biopolis, a state-owned life sciences center where top scientists are using stem cells to search for a diabetes cure, and a leader of the team that cloned Dolly the sheep is continuing his research.

KOREA Since the U.S. limited funding on embryonic stem cell research, Seoul National University has developed 36 stem cell lines, one of the world's largest collections.

CHINA Beijing and Shanghai have major stem cell centers, and overseas patients with life-threatening illnesses are traveling to China for experimental treatments using stem cells.

AUSTRALIA Last year started allowing the use of embryos for stem-cell research; spending \$25 million on a new national stem cell center near Melbourne that will house up to 200 scientists.

Singapore in funding ES Cell's effort to find a cure for the disease. Many governments have been asking themselves "Since the U.S. doesn't seem to be taking a lead role, why don't we?" observes Goldstein.

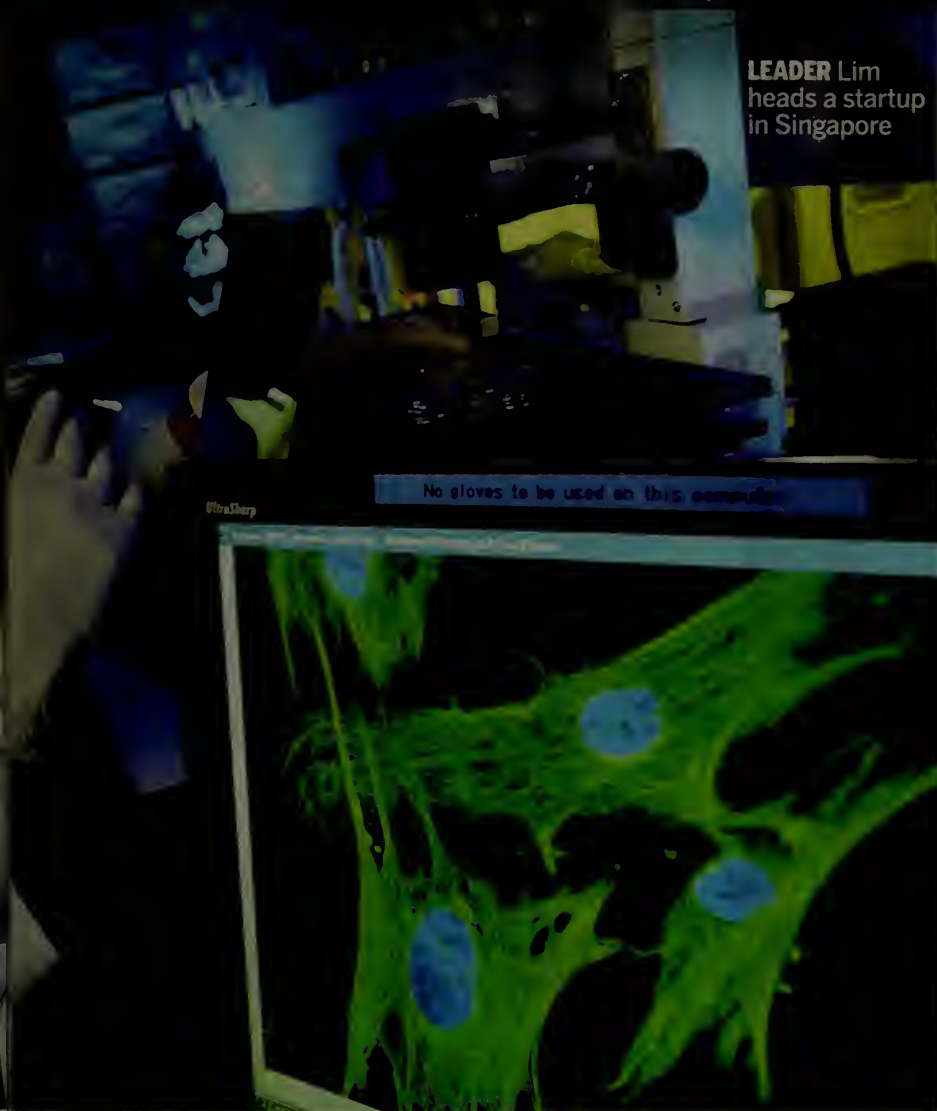
What has created this opportunity? President George W. Bush put drastic restraint on federal funding for embryonic stem cell research in the three years ago because of religious conservatives' opposition to the use of the cells, which come from embryos left over after in-vitro fertilization. Even in the different religious traditions of Asia, the debate isn't heated. "We don't have an ideological roadblock," says D. P. Subramanian, chairman of the Indian government's stem cell task force.

Despite the progress Asians have made, many scientists say they remain far away from developing therapies using stem cells.



Data: BusinessWeek

LEADER Lim
heads a startup
in Singapore



Nevertheless, there is anecdotal evidence of early progress. A Chinese lab is looking into using stem cells to treat amyotrophic lateral sclerosis (ALS), or Lou Gehrig's disease. And in October, researchers at Korea's Chosun University said they had transplanted stem cells into a 37-year-old woman suffering from a spinal cord injury, partially restoring her ability to walk—though there has been no independent confirmation of the claim. "We didn't expect the patient to recover like this," says Chosun professor Song Chang Hun. "It's almost like a miracle."

Some governments have focused on importing talent. China, for instance, has recruited scientists from top universities in the U.S. to run research centers on the mainland. And in Singapore, 32-year-old Sven Müller Bested, a self-described "line jockey" from Denmark, is now the chief technology officer for Cordlife, a company that focuses on preserving and researching stem cells found in human umbilical cords. Bested and others involved in stem-cell work say the government's unflagging support gives confi-

dence to scientists worried about shifting political winds. "You won't find out overnight that what you've been working on for five years has been banned," he says.

Still, Asian countries are far from assured of leading the way in stem cells over the long term. One big question is whether local universities can produce enough top-notch researchers, since relying on imported scientists won't work in the long run. Another concern is what some critics see as a lax approach to oversight and ethics in some labs, including the use of stem cells drawn from fetuses aborted in the second trimester in China.

More worrisome for the Asians is the growth in alternative sources of funding for stem cell research in the U.S. While Bush's reelection ensured that the National Institutes of Health will not be opening its coffers to U.S.-based researchers in embryonic stem cells, on

The Asian players will soon face a strong rival: The state of California

Election Day voters in California approved Proposition 71, which will provide \$300 million a year to scientists conducting such research in the state. That will make it harder for the Asians to attract top scientists. Seoul, for instance, has dished out a total of just \$27 million over the past two years in public money for stem cell research. Funding in Singapore and other countries also pales in comparison to what California plans to spend. "There's going to be a very impressive network" in California, says Randy Schekman, a professor of cell and developmental biology at the University of California at Berkeley and an adviser to the Singapore government. While he admires the "gung ho attitude" of Singaporean policymakers, Schekman says Proposition 71's basketload of money could overwhelm what the Asians can offer. "We are going to attract an awful lot of people who will be eager to move" to the Golden State, says Schekman.

California may not be the only worry. Britain has a relatively liberal policy toward stem cell research and may soon kick-start funding for it. And at least five other U.S. states are looking to fund stem cell research, too. Even some of Asia's most prominent boosters concede that the region will have a tough time matching what the Americans have to spend. Singapore is building a scientific community, but currently "it's sub-optimal," says Colman. "The people who wrote Prop 71 are trying to recruit people right now. And when those top people go, so will their teams."

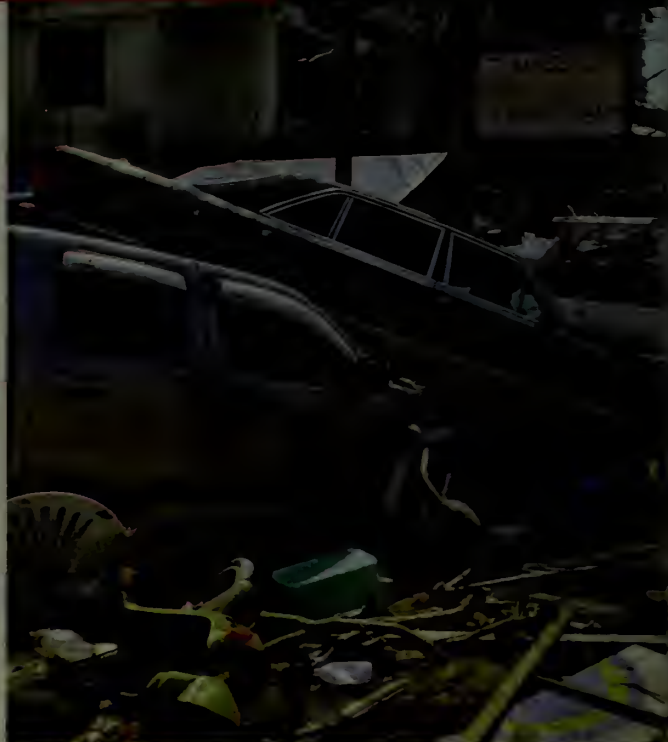
The Asians insist they're still in the running, and that increased funding for research—wherever it takes place—will ultimately help everyone in the field. "I don't think any one country can monopolize stem cell research," says Susan Lim, chairman of Stem Cell Technologies, a Singapore startup focusing on ways to extract adult stem cells from fat tissue. California's research effort will attract attention, but "Korea, Singapore, and China will be even more committed to pursuing it," says Hwang Woo Suk, a researcher at Seoul National University. Now that they have a strong foothold, the Asians aren't about to give up, even as the climate for stem cell research improves elsewhere. ■

—By Bruce Einhorn in Singapore, with Jennifer Veale in Seoul and Manjeet Kripalani in Bombay

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News International



DISASTERS

THE TSUNAMI'S TRAGIC TOLL

A vast catastrophe will bring painful economic costs, too

AT THIS TIME OF YEAR, the southern Thai beach resort of Ao Nang is normally brimming with carefree tourists swimming, diving, sunbathing, and dining in casual waterfront restaurants. But in the aftermath of the tsunami that killed tens of thousands of people around the Indian Ocean, that festive atmosphere disappeared. Dozens of bystanders look on as divers bring in remains of people killed by the waves. The fleet of tourist boats lies in ruins. And Duang Jai Na Vong remembers clinging to metal rods on the ceiling in his restaurant to keep from being swept away by the waves. "The water just didn't stop," he says. Now he has to worry about getting his business back on its feet: "It's going to take two or three months to repair the damage, which takes us almost to the end of the [peak] season."

The Dec. 26 tsunami is above all a tragedy for the region's poorest citizens. Two days after the wave struck, the death toll in India, Indonesia, Sri Lanka, Thailand, and other Asian nations topped 50,000. In Sri Lanka, about 1.5 million people—7.5% of the population—were left homeless or lost their livelihood. In Indonesia, more than 16,000 people perished—mostly poor residents of isolated coastal communities. In India, fishing villages in the southern state of Tamil Nadu were wiped out by the waves. Many villages "had

PHUKET WRECKAGE

Total outlays for rebuilding may top \$10 billion



protection," says Abraham Tharakan, president of the Seafood Exporters Association of India, who visited some of the hardest-hit areas the day after the disaster. "It's all debris."

The economic cost will be huge, too. The total price for rebuilding will likely top \$10 billion, according to insurer Munich Re. Seaside communities will struggle from the loss of hundreds of thousands of homes and small businesses. The Thai island of Phuket, which depends on booming business during the Christmas and New Year holidays, faces months of rebuilding, and many tourists are canceling. Hotels fear that visitors may not come back for the key lunar New Year holiday in February. Madras, India's fifth-largest city,

may suffer power shortages after the tsunami caused a nuclear power plant to be shut down. And governments across the region, already strapped for cash, now face the expense of relief and reconstruction. "It's huge, a scale not experienced in Asia since World War II," says Bob Broadfoot, managing director of Political & Economic Risk Consultancy Ltd. in Hong Kong. "There's going to be an immediate strain on social welfare systems."

BACK IN BUSINESS

STILL, THE TSUNAMI won't likely do much to slow the broad Asian economy. Brokerage Credit Suisse Group estimates that over the coming year the tsunami may cut growth in Thailand by about a half-point, and in Indonesia by a quarter-point. Most of Asia's major industrial areas were largely unaffected, so most commerce will continue uninterrupted. "This is a tragic one-off event," says T.J. Bond, a senior economist with Merrill Lynch & Co. in Hong Kong. "Catastrophes like this have an impact for one or two quarters."

Indeed, Thailand is already trying to get out the message that resorts are back in business. Destinations that were little damaged by the tsunami were accepting new guests within 48 hours of the disaster. "We're open as usual," says Preecha Chuenkadee, marketing manager for Kata Group of Resort Hotels, which runs three hotels in Phuket. Still, there's plenty of hardship ahead, and a lingering atmosphere of fear: Two nights after the tsunami struck, a rumor spread through Ao Nang that another wave was on the way, leading to a near-stampede as panicked diners fled beachside restaurants. The hope is that the fears will subside soon enough to give the region a chance to start rebuilding. ■

—By Ian Rowley in Ao Nang, and Bruce Einhorn in Hong Kong, with Vaudine England in Bangkok, and bureau reports

THE STAT

50,000

estimated death toll from the tsunami (as of Dec. 28)

Source: Bloomberg Financial Markets

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AUTOMOTIVE

REVVED UP FOR BATTLE

A Franco-Japanese venture aims to redraw Europe's small-car map

OUTSIDERS HAVEN'T been allowed a glimpse yet. But rivals are already feeling uneasy. Deep in the Czech Republic, in a town called Kolin, Europe's newest auto plant is being put through its final paces before a March debut. The ultra-low-cost manufacturing joint venture between Toyota Motor Corp. and PSA Peugeot Citroën combines Japanese production expertise with French parts-purchasing clout in Europe. And it is sure to up the ante for volume auto makers, who already have to worry about surviving on razor-thin margins. "It will set a new benchmark," says Carl-Peter Forster, president of General Motors Corp.'s European unit, which has announced 12,000 job cuts as part of a painful restructuring of its high-cost factories in Western Europe.

Brace yourself, GM. Watch out, Ford Motor Co. Take cover, Fiat. The imminent opening of the \$2 billion Kolin plant heralds a survival-of-the-fittest battle in Europe. The prize: mastery of Europe's \$50 billion small-car market, which already makes up 32% of total car sales and is luring an increasing number of customers from the mid-sized segment.

Kolin highlights how the rules of the game are being rewritten. European auto makers have long excelled at making iconic small cars that sold in massive volumes—from Fiat's Cinquecento and Volkswagen's Beetle to Renault's Twingo. But to win in small cars today, combatants must pack vehicles with costly high-tech innovations and still offer a rock-bottom sticker price. The European front-runners in that race are the French and the Japanese, who are wielding innovative manufacturing strategies to defend profits. "It will be clear how competitive the Kolin plant is when we announce the price of the new cars," says PSA's Daniel Marteau, vice-president in charge of co-

operation agreements. Analysts expect the cars produced in Kolin to be priced about \$10,000, the going rate for European minis. That price, though, will include features normally found in more expensive models, such as an electro-stability program and four airbags.

The Toyota-PSA venture will turn the heat on an already competitive marketplace. The streamlined Kolin plant will churn out a total of 300,000 small cars a year—100,000 each for Toyota, Peugeot and Citroën. The three models share nearly all their parts, except for exterior features such as the grill or headlights. Toyota's top managers say the Czech plant may even outperform Toyota's existing plants. The Kolin production line were designed and built in Japan by Toyota's suppliers and tested in a virtual factory to ensure a smooth rampup. It will be run by some 30 Japanese and 10 French managers, while engineers from Toyota's Tsutsumi factory in Toyota City will keep close tabs on the plant as well. The joint venture with PSA allows Toyota to shoulder the heavy expense of a new plant. "We needed a partner to get the right volume for costs," says Shuhei Toyoda, former president of Toyota Motor Europe who helped broker the venture with PSA.

Exactly how big a squeeze will the Toyota-PSA venture put on the competition? That depends on the success of the three models—the new Peugeot 107, the Citroën C1, and the Toyota Aygo (pronounced "I go"). Despite the extra space packed into these cars, analysts say, Toyota and PSA are likely to squeeze an operating profit of 3%-4% from their minis, compared with rivals who normally manage a profit of 1%-2% on similar models. Fiat, for one, is likely to see sales of its new 8,600 euro (\$11,500) Panda come under pressure, analysts claim. Meanwhile, Volkswagen is preparing a strike back with the Fox, a small-car model being built in Brazil.

The French and Japanese sister models will arrive in showrooms just as a stagnant European economy is sapping sales of bigger cars. "There is pent-up demand for affordable vehicles," says Christopher Stürmer, senior analyst at market researcher Global Insight in Frankfurt. Toyota and PSA, already primed for the toughest market conditions, should enjoy the ride. ■

—By Gail Edmondson in Frankfurt

A New Wave of Minis

A host of low-priced small cars are battling for market share in Europe

MODEL	LAUNCH DATE	PLANT LOCATION	PLANNED PRODUCTION
PEUGEOT 107	March, 2005	CZECH	100,000
CITROEN C1	March, 2005	CZECH	100,000
TOYOTA AYGO	March, 2005	CZECH	100,000
VW FOX	April, 2005	BRAZIL	100,000
FIAT PANDA	October, 2003	POLAND	300,000*

*Unit sales

Data: Compauto Report

EDITED BY PATRICIA KRANZ

Ukraine: Why the Road West Will Be Rocky

VIKTOR YUSHCHENKO BASED his presidential bid on a simple but powerful idea: that Ukraine's destiny lies with Europe, the Europe that believes in fair elections, transparent business dealings, and a free press. No surprise, then, that during a long and tumultuous campaign, Yushchenko repeatedly said that membership

in the European Union and NATO would be high priorities in his administration.

That pro-West administration looks set to begin soon. In a rematch of a rigged election that initially deprived him of victory, Yushchenko handed government-backed candidate Prime Minister Viktor Yanukovich a decisive defeat. The Ukrainian Central Electoral Committee on Dec. 28 declared Yushchenko the winner by 52.01% to 44.19%.

divisive Issue

IT IS NOT THAT HARD-won triumph doesn't mean moving Ukraine into the West's camp will be easy. The issue of EU and NATO membership, in particular, could split both Ukraine and Europe. In Ukraine, support for Western integration comes mostly in the Ukrainian-speaking west, where Yushchenko draws much of his support. Support for closer relations with Russia and other former Soviet bloc nations prevails in the Russian-speaking industrial east, which is Yanukovich territory.

Many in Europe, meanwhile, are reluctant to start the process that would bring Ukraine into NATO and the EU out of fear of poisoning relations with Russian President Vladimir V. Putin. "We can't allow Ukraine which is anti-Russian into the EU," says a German foreign policy analyst. Even EU members such as Poland, however, are already backing Ukraine's cause as another way to curb Russia's influence. Poland will not only support Ukraine's integration into the EU, we will fight for it," says Janusz Onyszkiewicz, a Pole who is

vice-president of the European Parliament. But, he adds, "it will take some time to convince our partners in Western Europe." In the U.S., the Bush Administration favors admitting Ukraine into NATO once requirements are met. But Washington would run the risk of straining relations with Putin in the short run. "This will be a big test of Bush's commitment to expanding democracy," says Jim Rosapepe, a former U.S. ambassador to Romania who serves on the boards of several European investment funds.

If Yushchenko does persuade Western nations to start membership talks, particularly in NATO, a new East-West struggle could ensue. "If Russia sees its influence in Ukraine as being ignored, it will obviously respond," says Mykhailo Pohrebinsky, a Kiev political analyst. One possible weapon: ramping up the price of oil and gas Russia sells to Ukraine.

That would hurt, but Ukraine could survive. Europe is now a major trading partner for Ukraine. Oleg Riabokon, a partner in Kiev's Magister & Partners law firm,

expects Yushchenko's victory to fuel an investment boom: Stock prices in Ukraine have risen 30% since Nov. 21. Russia's market plummeted during the same period following news that the government was selling the main asset of oil company Yukos. Instead of viewing Ukraine as a clone of Russia, the markets are starting to see the country as European. Now Europe just has to follow suit. ■

—By Roman Olearchyk in Kiev, with John Rossant in Paris



YUSHCHENKO EU and NATO membership is a priority

GLOBAL WRAPUP

HOW LOW WILL THE DOLLAR GO?

WITH THE EURO hitting highs against the dollar nearly every day, investors are wondering how low the dollar could go. Quite a few analysts think that the greenback will end up around \$1.40 per euro by yearend 2005, vs. the current rate of around \$1.36. But with the **Bush Administration** seemingly welcoming the dollar's fall and little sign of a serious effort to curb the gaping U.S. current account or budget deficits, some market participants are talking about more extreme scenarios. Exchange rates of \$1.70 or \$1.80 per euro no longer seem out of the question.

A BUMP IN THE ROAD FOR JAPAN'S MAZDA

IT WAS A MAJOR blow. On Dec. 24, **Mazda Motor Corp.** revealed that a fire at one of its main plants on Dec. 15 would cause production delays affecting some 35,000 vehicles, including top-of-the-line export models such as the RX-8 sports car. It's too early to say what impact the accident will have on earnings. Mazda plans to shift production to other factories. But the fire marks a setback, since the company had expected record profits this year.

Mazda has just begun to reap the gains of restructuring begun after **Ford Motor Co.** upped its stake in Japan's No. 4 auto maker to a controlling 33.4% in 1996. In November, Mazda reported a 68% jump in net profit, to \$169 million, on a 9% gain in revenue, to \$12.6 billion for the fiscal half ending Sept. 30. Ford has been counting on Mazda's earnings to boost the bottom line as it struggles to fend off Japanese rivals **Nissan Motor Corp.** and **Toyota Motor Corp.** in the U.S.

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The Best & Worst Managers of the Year

THE YEAR 2004 PROVED to be a time of great paradox. Executives in once-booming industries such as information technology and pharmaceuticals stumbled. Counterparts in supposedly sleepy segments like steel, oil, and heavy equipment hauled in more profits than they had seen in years. All the while, executives who presided over the scandals of the boom years were being paraded through courtrooms. Some of last year's strongest performances came from executives in a cleanup role: Ed Breen at Tyco and Gene Mulcahy at Xerox, who turned around troubled ships by combining no-nonsense leadership with strict financial controls. Just as dramatic were the flameouts. Marsh & McLennan's Jeffrey W. Greenberg resigned after New York State Attorney General Eliot Spitzer accused the insurance brokerage firm of bid-rigging and other no-nos. Some of the

The stalwarts stayed the course, while a few stars flamed out

starkest examples of good and bad management came from Washington. President George W. Bush owed his reelection to campaign manager Karl Rove, but was criticized for standing by Defense Secretary Donald Rumsfeld, who mismanaged the war in Iraq.

To decide which executives should be lauded and which deserved a different kind of renown, we surveyed our staff of more than 130 writers and editors in New York and in 20 bureaus around the world. And this year we top off our package with a visit to America's most popular manager, Donald Trump. His casinos may have filed for Chapter 11, but Trump has built a booming empire of fantasy around an improbable TV hit, *The Apprentice*. It's only fitting: In the rough and tumble reality show called Corporate America, it's a week-to-week proposition as to which CEOs survive—and which get fired.

» The Best Managers » Managers to Watch » Repeat Performers » Revenge of the Rust Belt » The Bush Team » New Managers » The Worst Managers » The Fallen Managers » Managers on Trial » Succession Screw-Ups » Trump's World

businessWeek online

For a look back at five years of Best and Worst Managers and interviews with some of this year's execs, go to www.businessweek.com/extras

The Best Managers

Talent, vision, and a gift for knowing a golden opportunity. It all came together last year for these execs

JEFFREY IMMELT

General Electric

NOBODY QUITE KNEW what to expect of Jeffrey R. Immelt when he took over the top job at General Electric Co. in September, 2001. GE had long thrived under the legendary Jack Welch, making it tempting to expect more of the same from his young successor. But Immelt, 48, has put his distinct imprint on GE's culture and strategy. Moreover, he has done it through a period of intense uncertainty—from the September 11 attacks through new regulations and a shaky economy.

Through it all, Immelt has stuck to his agenda for transforming GE in the 21st century. That has meant creating a much more customer-driven, global, and diverse culture—one that spawns innovation, embraces technology, and has the goods to grow internally in a slow-growth world. He has shaken up the portfolio, too, by edging out of lower-return

businesses like insurance with the spin-off of Genworth Financial in 2004, while buying stronger plays such as Vivendi Universal's entertainment assets and Amersham PLC, a British diagnostics and biotech giant. He even broke up the massive and often opaque GE Capital into four transparent businesses. "The biggest challenge is continuing to drive consistent growth in a world that is more volatile and has less economic growth," says Immelt.

It won't be easy. While the company forecasts 2005 earnings growth of up to 17%, 2004's growth is expected to be only 5% to 7%. Still, strong cash flow has Wall Street believing that Immelt can bring back the good times. The stock price was up more than 19% through late December. As Immelt proceeds with his vision of where to take GE, a growing number of investors are coming along for the ride.

KEY ACCOMPLISHMENTS

- Repositioned GE's portfolio with major acquisitions in health care, entertainment, and commercial finance.
- Created a more diverse, global, and customer-driven culture.



STEVEN REINEMUND

PepsiCo

SODA AND POTATO CHIPS don't exactly sound like a recipe for success in today's weight-obsessed, low-carb world. But Steven S. Reinemund has built PepsiCo Inc. into much more than a purveyor of junk food standards. Through constant innovation and savvy moves like the \$14 billion acquisition of Quaker Oats Co., Reinemund, 56, has created a nimble, \$27 billion food and beverage giant.

Every year, PepsiCo adds more than 200 product variations to its global portfolio of brands that includes Frito-Lay snacks, Pepsi-Cola sodas, Gatorade sports drinks, and Tropicana juice. Many are aimed at wooing ethnic tastes as well as satisfying health-conscious consumers.

But Reinemund's greatest achievement is in developing people more than products. While some rivals are mire

HECTOR RUIZ

Advanced
Micro Devices

AS A CHILD IN PIEDRAS Negras, Mexico, Hector Ruiz wanted to be an auto mechanic. As president, chief executive, and chairman of Advanced Micro Devices Inc., Ruiz has become Mr. Fix-it. When he took over financially strapped AMD in April, 2002, from the flamboyant Jerry Sanders, few people knew who he was, despite his long tenure at Motorola Inc.

Nevertheless, the soft-spoken executive has put AMD in the black for the first time since 2000. He's giving larger competitor Intel Corp. fits with AMD's hot-selling Opteron server and Athlon 64 desktop chips, and he has set the agenda for next-generation PC designs. "We're giving customers real choice," Ruiz says. It's no wonder AMD's shares rose 50% last year through late December.

Now, Ruiz, who has a PhD in quantum electronics, is loading his sling for more shots at Goliath Intel. After grabbing 10% of the mainstream server chip market, Ruiz is pushing

company engineers to launch multiple-core chips, which shrink several processors into the space of one, by the middle of 2005. Getting the superefficient, low-heat chips out on time would put AMD at least six months ahead of competing Intel offerings. Never one to think small, Ruiz has also set a goal to outfit 50% of the world with

sub-\$200 PCs by 2015.

Ruiz could go a long way toward fulfilling AMD's promising outlook by cinching another big deal he has labored over: Getting his Texas neighbor, Dell, to pick up AMD products after years of being an all-Intel shop. If Ruiz manages that, he could put AMD in the chips for a long time to come.

KEY ACCOMPLISHMENTS

- » Demonstrated the first mainstream dual-core chip, offering superefficient processing with low power consumption and heat dissipation.
- » Launched an initiative to sell low-cost PCs in developing countries in a bid to bridge the widening digital divide.

management challenges, PepsiCo has developed one of the deepest executive benches in Corporate America. Moreover, the diversity of that bench has proved to be an asset in tapping new markets. As Reinemund puts it: "To be a leader in consumer products, it's critical to have leaders who represent the population we serve." He personally plays a major role in mentoring and teaching off—both formally and informally. He also demands that everyone in the senior ranks do the same. The payoff: consistent



double-digit earnings growth and solid sales at a time when many of the company's staple products are under threat from fears over childhood obesity and other health concerns. PepsiCo has outperformed Coca-Cola Co. in boosting sales and has logged earnings growth that is more than double that of its rival. The company is expected to report 17% growth in earnings per share in 2004. One reason is the increasing strength of its operations in foreign markets such as India and China, thanks largely to the talent of local teams. PepsiCo's efforts to quench

consumers' growing thirst for noncarbonated beverages also helped boost the bottom line. For Reinemund, the key is making enough new bets to keep customers coming back while delivering strong shareholder returns.

KEY ACCOMPLISHMENTS

- » Developed a strong and diverse leadership bench that has helped PepsiCo tap new markets.
- » Attained consistent double-digit earnings growth through product innovation and smart marketing.

BEST MANAGERS



STEVEN SPIELBERG, JEFFREY KATZENBERG, AND DAVID GEFFEN

DreamWorks SKG

TEN YEARS AGO, DreamWorks SKG didn't exactly have a boffo premiere. The studio, founded by Hollywood moguls Steven Spielberg, Jeffrey Katzenberg, and David Geffen, suffered through its share of early bombs. Video games went nowhere, TV shows flopped, and a music business was sold off. Even with Academy Award winners like *American Beauty*, live-action hits were few and far between. That was before the three amigos discovered a green ogre named Shrek. Since then, DreamWorks has been the hottest studio this side of Steven P. Jobs's Pixar Animation Studios. In

October, Spielberg, Katzenberg, and Geffen had a blockbuster \$812 million initial public offering of the animation unit—and then saw the stock zoom by more than 45% the next month. “There were times when it wasn’t for the fainthearted,” admits Katzenberg, 53.

Indeed, since Dreamworks ditched traditional animation (which gave it bombs like 2003’s *Sinbad*), its edgier computer-generated releases

have included megahits like this fall’s *Shark Tale* and summer’s *Shrek 2*, which grossed \$436.7 million in the U.S. and passed Pixar’s 2003 *Finding Nemo* as the highest-grossing computer-generated animation film. The animation unit is run by Katzenberg, the hyperkinetic onetime Walt Disney Co. studio chief who teases his former bosses with subtle Disneyland references in his *Shrek* flicks. Katzenberg has a film in the works about a London rat that no doubt will be likened to Disney’s you-know-who.

DreamWorks Animation turned a \$187.2 million loss in 2003 into a \$196 million profit in 2004, estimates

Merrill Lynch & Co., with revenues of \$1.1 billion. It plans to continue turning out two films a year—a hefty load for films that generally take up to four years to make. Next up: *Madagascar*, about shipwrecked animals from the Central Park Zoo. *Shrek* is in the works.

Although it has emerged as an animation powerhouse, DreamWorks hasn’t abandoned live-action filmmaking. Spielberg, 58, is directing a remake of the 1953 classic *The War of the Worlds*, starring Tom Cruise. And Geffen, 61, who engineered the IPO, will use his legendary dealmaking skill as CEO of the film studio. Geffen became a billionaire by starting music companies and selling them to Warner Communications Inc. and MCA. This time around, he has sold investors a stake in one of Tinseltown’s hottest studios.

KEY ACCOMPLISHMENTS

» In the spring, the computer-animated *Shrek 2* set a record with a gross of \$436.7 million.

» Had one of the year’s hottest IPOs, pulling in \$812 million. Stock zoomed by 45% the following month.

ROBERT NARDELLI

Home Depot

WHEN BOB NARDELLI took over the corner office at home improvement retailer Home Depot Inc. in December, 2000, he found a company headed for trouble. Nardelli's own missteps exacerbated the problem: A plan to centralize purchasing led to out-of-stock items early on. Things grew so bad that same-store sales shrank in 2001 and 2002. Nardelli, 56, the former head of General Electric Co.'s Power Systems unit, persevered. He sank \$14 billion into renovating outdated stores, investing in new technology such as self-checkout lanes and cordless power tools, and upgrading merchandise. He expanded to Mexico, China, and other regions to tap the growing

homeowner market. And he bet big that aging baby boomers in the U.S. would spruce up their empty nests.

Now those moves are paying off. In the third quarter, sales jumped 13.1%. Nardelli raised his goal for annual profit growth last year to about 20% from 10% to 14%. The company sits on \$3.4 billion in cash. With 2005 revenues headed to \$80 billion, Home Depot is the No. 2 U.S. retailer after Wal-Mart Stores Inc. Nardelli calls it the "sweetest spot in retailing."

KEY ACCOMPLISHMENTS

►► Turned a \$46 billion company focused on big-box stores into a \$70 billion chain with urban, suburban, and international outlets.

►► A ruthless drive for efficiency, such as centralizing purchasing and investing in technology, pushed margins above 30%.



JACK ROWE

Aetna

WHEN JACK ROWE became chief of Aetna Inc. in September, 2000, he walked to a company that had too many unprofitable members, a lousy reputation among doctors, and a bleeding bottom line. Rowe, also a retired geriatrician, has since made the Hartford health insurer a profitable innovator and what many consider to be the physician-friendliest

player in the industry.

For Rowe, 60, last year was especially sweet. After 14 straight quarters of reductions in membership, Aetna increased its base by 750,000 members in 2004, to roughly 13.7 million, and expects to exceed that this year. Its stock

price was up about 85% through late December and the company is expected to report a 33% jump in profits, to \$1.1 billion, for 2004, says analyst John Rex of Bear, Stearns & Co.

Rowe's prescription for profits has been bitter medicine for some, with double-digit rate hikes, job cuts, and a pared membership base. But the Aetna chief is also bringing much-needed innovation to health care.



KEY ACCOMPLISHMENTS

► Increased membership profitably with innovative service offerings and smart financial management.

► Contained medical-cost increases through disease-management programs and other initiatives.

Managers To Watch

MICHAEL CHERKASKY

In October, after Marsh & McLennan Cos.'s insurance scandal broke and CEO Jeffrey



Greenberg was ousted, the financial-services giant tapped Michael G. Cherkasky, 54, to head up the recovery effort. Cherkasky's challenge is huge: Restoring the \$12 billion conglomerate's reputation and shoring up its finances.

JAMIE DIMON

After a four-year tenure as CEO of once-distressed Bank One, Jamie Dimon orchestrated the \$58 billion



takeover of his bank by J.P. Morgan Chase & Co. for a 15% premium in January, 2004. In June, 2006, Dimon, 48, will succeed Morgan CEO William B. Harrison Jr., but his attention to costs is already showing. Wall Street will be watching to see if Dimon can take the operation to even greater heights.

SALLIE KRAWCHECK

As newly appointed CFO and head of strategy at Citigroup Inc., Sallie Krawcheck, 40,



is not just one of the most respected women on Wall Street, she is also one of the most powerful. An analyst by training, her rapport with institutional investors will help her excel in her new position, the start of what is essentially on-the-job training—possibly for the CEO job somewhere down the line.

BEST MANAGERS

JOSEPH TUCCI

EMC

WITHIN MONTHS of being tapped to run data-storage giant EMC Corp. in early 2001, Joseph M. Tucci got the wind knocked out of him. The dot-com crash sent sales and profits through the floor and took EMC's once-buoyant stock price with them. Suddenly the company, a Wall Street darling during the 1990s, "was going headlong for a cliff," says John McArthur, group vice-president at market researcher IDC.

Not anymore, thanks to Tucci's deft turnaround. The 57-year-old chief executive cut costs, reached out to customers, and expanded in software and services to reduce the company's reliance on sagging hardware sales. In the first nine months of 2004, revenues were up 34%, to \$5.9 billion, and net income doubled, to \$551 million. Tucci's most impressive move may have been facing up to the changes roiling techdom. With customers demanding easier-to-use, less expensive alternatives, he revived a line

KEY ACCOMPLISHMENTS

» Revived growth by pushing sales of new, easier-to-use, less expensive storage gear.

» Made \$3.6 billion worth of software deals, boosting margins and broadening EMC's appeal to customers.

of modular storage gear that EMC had inherited when it bought Data General Corp. in 1999. Pushing it through a new batch of resellers, as well as PC king Dell Inc., Tucci made it one of his fastest-growing businesses. That's good, because EMC's pricey high-end machines seem destined for single-digit growth.

Not that Tucci is taking EMC low-rent. To boost margins and broaden EMC's appeal, he has made almost \$4 billion in acquisitions of software companies in the past 18 months. Tucci is hoping that packaging his range of products and services together will make EMC an indispensable ally for corporate customers.



GARY FORSEE

Sprint

GIVE GARY D. FORSEE credit for his vision. After taking the reins at Sprint Corp. in March, 2003, he recognized that for his company to excel in the sluggish telecom sector, it would have to jettison its image as a long-distance provider. So Forsee combined Sprint's wireless and wireline businesses to create a company that could provide everything from cellular to local phone service. Then, buoyed by a stock that had soared 50% from a year earlier, Forsee agreed to a \$35

billion merger with Nextel Communications Inc. in December. He'll serve as CEO of the combined Sprint Nextel.

Forsee's telecom giant will have the heft to battle Cingular Wireless LLC and Verizon Wireless and the means to forge the broadband future. Sprint was already partly there, thanks to Forsee. He struck deals to let Virgin Mobile Telecoms Ltd., AT&T,

and others lease Sprint's wireless network so they could market services that would compete with Sprint's own offerings. Radical? Maybe, but it got Sprint 3 million new users. And he teamed with cable operators to deliver residential phone service, giving Sprint access to 95% of U.S. households that have phones. That's Forsee—always willing to break with convention to w

KEY ACCOMPLISHMENTS

» Combined Sprint's wireless tracking stock with that of the parent company, paving the way for Sprint's merger with Nextel.

» Unconventional partnerships with cable operators and rival telcos added millions of consumers to Sprint's network.

JOHN HENRY

Boston Red Sox

JOHN W. HENRY LONG ago earned his fortune—and a reputation as one of the nation's premier players in the global futures markets. But in 2004, Henry may have achieved immortality by leading the Boston Red Sox to their first World Championship since 1918, reversing the most fabled curse in sports. This triumph was due to more than the inspired play of a team that rallied from 0-3 in the American League Championship Series to beat the New York Yankees.

Henry, 55, set the stage for victory by aggressively boosting revenues after he and his partners—including TV producer Tom Werner and veteran baseball exec Larry Lucchino—bought the Red Sox for a record \$690 million in early 2002. They made the most of Fenway Park, the oldest stadium in Major League Baseball, by squeezing in more seats and then charging the highest prices for home games, all of which sold out. At the same time, they started

broadcasting home games in high definition on their 80%-owned cable sports network, New England Sports Network—helping it routinely win in regional prime-time ratings.



KEY ACCOMPLISHMENTS

» Broke the most fabled curse in sports, when his Boston Red Sox won their first World Championship since 1918.

» Sold out all 81 home games for the first time in team history.

All of this turned the Sox into baseball's second-most-lucrative franchise and gave it the financial muscle to take on the Yankees, who opened the season with a record \$184 million payroll. The Sox were second, at \$127 million.

Henry—a numbers genius, whose proprietary futures-trading system consistently produces double-digit returns—closed the gap with sabermetrics. That's a system for mining baseball stats to find undervalued players while avoiding long contracts for aging stars—such as pitcher Pedro Martinez—whose performance is likely to decline. Henry built baseball's most effective team but won't settle for one championship. After ending an 86-year drought, he's aiming for a dynasty.

Managers To Watch

JONATHAN MILLER

AOL CEO Jonathan F. Miller has much to prove at the onetime internet juggernaut. Two years to the job of turning around the ailing Warner's struggling online division, Miller, 48, has had some success selling online ads. But AOL, viewed as too dull and fussy by the generati, is losing subscribers.



PATRICIA RUSSO

After losing \$29 billion over three years, Lucent Technologies posted a \$2 billion profit in fiscal 2004. Credit drastic cost-cutting by CEO Patricia Russo and an uptick in telecom customer spending. Lucent's biggest buyer, Verizon Communications Inc., is expected to boost its spending again this year. But Russo will have to keep adding to her client roster if she's going to ensure that the once-proud tech giant's recovery is permanent.



JOHN THOMPSON

Thanks largely to strong sales of antivirus software, Symantec Corp.'s 2004 revenues are expected to top \$2.43 billion, a 42% increase from 2003. Net income is likely to increase 50%, to more than \$500 million. But now comes CEO John Thompson's biggest challenge: On Dec. 16 he announced a \$13.5 billion blockbuster merger with storage software maker Veritas Software Corp. Few software companies have made successes of large mergers.



SERGEY BRIN & LARRY PAGE

During Google's meteoric rise, co-founders Sergey Brin and Larry Page couldn't miss. They insisted on a clutter-free search page while others littered their sites with ads. They shelved pricey marketing plans while dot-coms were wielding sock puppets. But now Google must answer to demanding public investors. Brin and Page, who as presidents still call most of the shots, must prove adept at steering their publicly accountable company.



BEST MANAGERS

HENNING KAGERMANN

SAP

GOOD MANAGEMENT requires smart thinking and crisp execution, but a little bit of luck doesn't hurt. Henning Kagermann, 57, CEO of software giant SAP, has had plenty of all three in the past year. Under the steady hand of the cerebral manager, the Walldorf (Germany) company has more than survived the tech bubble—it has strengthened its position as the global leader in software for accounting, sales management, and manufacturing. Profits for 2004 are expected to surge 20% over the previous year, to \$1.7 billion, on revenues that grew 6.7%, to \$9.9 billion. SAP's suite of software packages now serves as the central nervous

system for more than 24,500 of the world's largest companies, making it the No. 3 software company on the planet.

Kagermann deserves credit for keeping SAP's costs in line and hanging on to budget-conscious customers during the downturn. His task got an unexpected boost from the protracted campaign by Silicon Valley-based rival Oracle Corp. to take over software maker PeopleSoft Inc. Many customers were nervous about the outcome, so they turned to stolid SAP. It helps, too, that under Kagermann, who took over as CEO in May, 2003, after sharing the job for five years with Chairman Hasso Plattner, SAP has remade itself as the industry's honest broker. Rather than locking customers into its own products, SAP offers tools that tie competing packages into a seamless whole. Analysts forecast revenues will climb another 10% this year, surpassing Oracle's expected 8% growth. Success like that depends on a lot more than luck.

KEY ACCOMPLISHMENTS

» Kept a tight lid on costs, which helped boost profits 20%, to \$1.7 billion.

» Tied SAP's software to other companies' products, helping to win over a slew of new customers.



ANNE MULCAHY

Xerox

ANNE M. MULCAHY IS not someone who nurtured fond dreams of a desk in the corner office. Even today, after 3½ years running Xerox Corp., Mulcahy, 52, seems a little surprised that fate brought her to this spot.

When Xerox' board chose Mulcahy to lead the Stamford (Conn.) copier maker back in August, 2001, the company was in terrible shape. It was fighting the Securities & Exchange Commission over accounting practices, and her predecessor had flamed out after trying to overhaul Xerox' powerful sales organization. The biggest problem of all: \$14 billion in debt. Bankruptcy was a real possibility. But Mulcahy proved relentless in pursuing a fix. After making sharp staff and business cutbacks, bringing in a new chief financial officer, and meeting

with innumerable customers, she stabilized Xerox. By the end of this year, its debt will be down to \$9.8 billion.

Mulcahy has spent the past two years trying to move forward again. She faces tough competition from Hewlett-Packard, Canon, and others. But she has posted respectable numbers: Though Xerox stock is nowhere near the highs of the late 1990s, in 2000, it rose 22% in 2004 through late December, compared with 9% for the Standard & Poor's 500-stock index. And after meeting earnings expectations in each of the past 10 quarters, Mulcahy expects new products to drive a sales increase in 2005—the first for Xerox since 1999. "Turnaround or growth, it's getting your people focused on the goal that is still the job of leadership," she says.

KEY ACCOMPLISHMENTS

» Pushed for faster decision making and instituted lean Six Sigma to improve efficiency.

» Cut debt and boosted cash flow, to an estimated \$1.5 billion in 2005, while maintaining research and development spending.



EDWARD BREEN

Tyco

WHEN EDWARD D. Breen took the helm of Tyco International Ltd. in the summer of 2002, many people thought the disgraced conglomerate was headed for bankruptcy, just like Enron Corp. In 2004, Breen proved them dead wrong. Under his leadership, Tyco has more than survived the scandalous conduct of former Chief Executive Dennis Kozlowski—who in early 2005 will be retried on charges that he looted the company. Indeed, Tyco now has a bright future.

Breen, who came to Tyco from Motorola Inc., where he

was president, moved aggressively to clear the biggest clouds looming over the \$40 billion company. He slashed debt to \$16.7 billion, from a peak of \$28 billion, regaining an investment-grade rating. He ordered a review of Kozlowski's accounting, then rebuilt the audit staff. And he worked to

KEY ACCOMPLISHMENTS

» Brought Tyco back after executive scandals and a liquidity crunch nearly killed it.

» Tripled net earnings and regained an investment-grade rating on Tyco's bonds.

make Tyco a model of corporate governance, starting by replacing the entire board and virtually all senior executives.

Now Breen is focused on generating growth. Sales surged 12%, to \$40.2 billion, in the fiscal year ended Sept. 30, and net income tripled to \$2.9 billion, thanks in part to a restructuring that improved margins. Breen still has some big challenges, including shareholder lawsuits. But investors are clearly betting on him. The stock has doubled since the end of 2002, giving Tyco a market value of \$73 billion. That's not as high as the \$120 billion peak reached under Kozlowski. But it's far above what anyone thought possible when Breen arrived.



Managers to Watch

PAUL OTELLINI

In May, Paul S. Otellini will become Intel Corp.'s first CEO without an engineering degree. But the real reason he deserves increased scrutiny is because of a string of product snafus during his tenure as COO. Intel had the slowest growth in 2004 among the top chip vendors. Otellini must revitalize Intel and succeed in conquering new markets.



BRADY DOUGAN

Credit Suisse First Boston LLC has a habit of running through CEOs. Brady W. Dougan, 45, is the sixth person in 15 years to accept the challenge of making Credit Suisse Group's unruly investment bank as profitable as its peers. Dougan has yet to boost earnings significantly. And many of the firm's top brass bolted after CSFB's last chief, John J. Mack, was ousted in July. This turnaround may be tough.



HENRY McKINNEL JR.

Pfizer CEO Henry A. McKinnell Jr. has a lot on the line. With a study showing his painkiller Celebrex may pose a heart attack risk, McKinnell, 61, will have to decide how to respond. Even if the drug remains on the market, Pfizer is likely to face plenty of lawsuits alleging injury. And the company will likely get a decision in 2005 on a patent challenge to its \$10 billion cholesterol agent, Lipitor. A loss there would be huge.



BEST MANAGERS



PHIL KNIGHT

Nike

PHILIP H. KNIGHT GOT his start selling Japanese sneakers from the trunk of his car. Nearly 30 years later the former University of Oregon distance runner has built a \$12.3 billion sports behemoth. At 66, Knight, 66, is finally stepping back from running Beaverton, Ore.-based Nike Inc., having pulled it away from the brink of irrelevance and whipped it into the best financial shape ever.

In the 1980s and 1990s, Knight forever changed the rules of sports marketing with huge endorsement contracts and in-your-face advertising. Later, Knight and his team transformed high-performance sports equipment into high-fashion gear. Then, just as suddenly, Nike lost focus. In early 2000, kids stopped craving the latest basketball sneaker. Nike's image took a huge hit from its labor practices. Sales slumped, and costs soared.

Thus began Knight's second act. He revamped management and brought key outsiders to oversee

LINUS TORVALDS

Open Source Development Labs

LINUS TORVALDS, A SHY 34-year-old Finnish programmer, may seem an unlikely choice to be one of the world's top managers. But Linux, the software project he created 13 years ago while a university student, is now one of the most powerful influences on the computer world. The operating system, built by volunteers and distributed in commercial and free versions, is popular with

corporations because it's typically cheaper than Microsoft Corp.'s Windows and offers customers an alternative to being locked into Microsoft products. And Linux has been causing Microsoft headaches aplenty: According to market researcher IDC, Linux held 21% of the server computer market in 2003, compared with 58% for Windows.

Torvalds, now employed as a fellow by Linux trade group

Open Source Development Labs Inc., coordinates the output of a few dozen volunteer assistants and more than 1,000 programmers scattered around the globe. They contribute code for the kernel—or core piece—of Linux. He also sets the rules for dozens of tech companies that have lined up behind Linux, including IBM, Dell, Hewlett-Packard, and Intel.

While basic versions of the operating system are available for free, Linux is having a considerable financial impact. IDC expects the total market for Linux devices and software to increase from \$11 billion last year to \$35.7 billion by 2008. Torvalds has quipped that his job is a lot like “herding cats.” But these cats are all inclined to move in only one direction—his.

KEY ACCOMPLISHMENTS

- » Created the core piece of the Linux operating system, which launched a software revolution.
- » Turned Linux into the No. 2 server operating system in the world, after Windows.



nances and apparel lines. Knight devoted more energy to mundane details such as developing top-flight information systems, logistics, and supply-chain management. Today, Nike's earnings are as volatile and less fad-driven. And it still spins off tons of cash. In the fiscal year ended on May 31, Nike turned nearly \$1 billion, up 7% from the previous year, on 15% higher sales. Knight says this is the moment to relinquish some of his executive responsibilities. In mid-November he named as CEO William Perez, 57, formerly chief of S.C. Johnson & Son Inc. As Nike's largest shareholder, Knight will remain chairman. His job now is to make sure newbie Perez can sprint with the best of the Nike veterans.

KEY ACCOMPLISHMENTS

- Transformed a volatile, fad-driven marketing and design company into a more shareholder-friendly company.
- Hired outsider William Perez, CEO of household products company S.C. Johnson, to succeed him as CEO.



CHUNG MONG KOO

Hyundai

FEW GAVE CHUNG Mong Koo much of a chance when he took the helm of South Korea's largest carmaker, Hyundai Motor Co., in 1999. After all, in his 24 years running Hyundai's after-sales service unit, the bland son of founder Chung Ju Yung didn't express any grand vision for the auto business. Turns out, he had been trained to deliver what

the company needed most: better quality.

This year, Chung, 66, made good on his promise to boost Hyundai's quality to "Toyota levels." J.D. Power & Associates' 2004 survey of initial quality—which counts complaints in the first 90 days of ownership—showed the Korean auto maker had virtually caught up with Toyota Motor Corp. And

Hyundai's Sonata was the top-ranked car in the "entry midsize" category.

Now Hyundai is on a roll. Despite a recent slump in Korean consumer spending that led to a 10% drop in domestic sales, the company expects a 2004 operating profit of some \$2.4 billion, up 17% from 2003, on sales of \$25.2 billion, up 8%. In China, Hyundai is expected to have sold 150,000 cars in 2004—triple its 2003 sales there.

In 2005, Hyundai will start building a revamped Sonata for the U.S. market to challenge Toyota's popular Camry. The new Sonata and Tucson sport-utility vehicle will also be key in efforts to expand in Europe, China, and smaller markets. With Chung at the helm, Hyundai now stands a chance of racing past its rivals.

KEY ACCOMPLISHMENTS

- Turned the company from the butt of talk-show jokes into a leader in customer-satisfaction surveys.
- Boosted Hyundai's presence in the U.S., Europe, China, and India, resulting in record sales and profits.

Managers to Watch

ROGER DEROMEDI

CEO Roger K. Deromedi, 51, is setting Kraft Foods Inc., the nation's largest foodmaker, in shape. He's lining up top brands and shedding underperforming units. But Deromedi needs to show that Kraft, which could be spun off from Unilever Group Inc. later this year, can boost its bottom line.



BRENDA BARNES

Can Brenda C. Barnes, 50, bring focus to Sara Lee Corp., the food, apparel, and consumer-products giant? That was her mandate when she joined the company in July as president. It's also something CEO C. Steven McMillan has failed to do. Barnes, a former PepsiCo Inc. exec, has already gotten down to work, announcing in October that Sara Lee will shed 60 brands. Still, the company is playing catch-up to more focused rivals with stronger labels.



JOSEF ACKERMANN

Deutsche Bank Chief Executive Josef Ackermann needs to make his numbers in 2005. The Swiss-born banker has added muscle to the company's investment banking business. But the financials lag way behind those of top rivals. More troubling is a possible retrial on criminal charges connected to Ackermann's role as a board member at another company. Even without that, Ackermann will have his hands full pushing through a restructuring.



EDDIE LAMPERT

The big question in retail is whether Edward S. Lampert's planned merger of Kmart Holding Co. and Sears, Roebuck & Co. will work. The deal would accelerate Sears' move out of the mall. But it's a long shot whether Lampert, 42, can fix two retailers that continue to lose sales. What's more likely is that Lampert will invest cash elsewhere, as his hero, Warren Buffett, did with a declining textile mill called Berkshire Hathaway.



BEST MANAGERS

STEVEN MURPHY

Rodale

WHEN STEVEN Murphy was hired to be president of Rodale Inc. five years ago, the cuff-linked New York executive seemed an odd fit for the Emmaus (Pa.) publisher that began some 60 years ago by putting out journals on organic farming. As it turns out, the pairing has been anything but odd, as Murphy, 50 and now CEO, expertly helped Rodale exploit America's continuing health and dieting craze. Rodale ended 2004 with record magazine advertising revenues, one of the industry's hottest titles in



Men's Health, and four best-selling books, including *The Abs Diet* and a cookbook spin-off of Rodale's popular *The South Beach Diet*.

The family-owned Rodale doesn't disclose profits. But it

does say profits have nearly doubled since 2002; revenues in 2004 rose 12%, to \$550 million. Among Murphy's achievements last year was adding two new titles to Rodale's stable of eight magazines with the launches of the upscale men's mag *Best Life* and *Women's Health*. Meantime, the

abs-centric *Men's Health* closed out the year with more than 1,000 ad pages for the first time, up 14% over 2003.

Murphy has recruited big executive talent to the once-sleepy company, including former Sony Music Entertainment Senior Vice-President Ken Citron, who became chief technology officer in May. "Change is imperative," says Murphy. So far, that mandate has brought a healthy glow to Rodale.

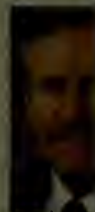
KEY ACCOMPLISHMENTS

- ▶ Increased the volume of magazine ad pages by an estimated 10% in 2004, vs. about 3% for the industry.
- ▶ Helped build the South Beach Diet into a \$280 million franchise, with three book titles and a Web site with 350,000-plus subscribers.

Manager To Watch

DENNIS FITZSIMONS

A circulation scandal at *Newsday* and *Hoy*, sliding readership at the Los Angeles *Times*, and softness in its TV unit are hammering results at Tribune Co. CEO Dennis J. FitzSimons, 54, been forced to ax jobs to cut costs. Clearly, getting its Chicago Cubs to the World Series is no longer FitzSimons' toughest task.



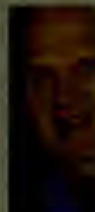
REUBEN MARK

In Reuben Mark's 20 years at the helm of Colgate-Palmolive Co., he has had a remarkable track record of profit growth based on a strategy of steady improved efficiency. It worked well until Procter & Gamble innovation and heavy marketing knocked down profits. Now Mark, 65, has to manage a painful restructuring and a race among three possible successors.



BRUCE WASSERSTEIN

Lazard LLC Chairman Michel David-Weill and Head Bruce Wasserstein fought in 2004 over the firm's future. David-Weill finally agreed to let Wasserstein take over. But if the brash dealmaker fails to list shares by the end of 2005, his contract terminates. If he succeeds, Lazard stands to raise a lot of capital, but much of the money would be used to buy out nonworking partners.



JERRY PERENCHIO

Univision

JERRY PERENCHIO, who runs Univision Communications Inc., has an iron grip on America's 40 million Hispanics. From a single Spanish-language TV station, he has put together a media colossus whose networks outdraw the big U.S. networks among 18-to-49-year-olds in prime time. Perenchio has added music labels and TV stations. Last year, he paid \$3.4 billion for Hispanic Broadcasting, making Univision the nation's largest Spanish radio company.

That wide reach has helped win over advertisers such as Miller Brewing Co.,

which will spend \$100 million over three years on Univision outlets. Net income rose 95% through the first nine months of 2004, to \$188.7 million, on sales of \$1.3 billion. For Perenchio, it's good to be *el rey*.

KEY ACCOMPLISHMENTS

- ▶ Increased Univision's 18-to-49-year-old audience by 8%. Now draws more Hispanics in that group than ABC, NBC, Fox, and NBC-owned Telemundo combined.
- ▶ Integrated Hispanic Radio, acquired in 2003, and boosted net income by 95%, to \$188.7 million, through September.





THIS IS NOT SPEND MANAGEMENT.

ARE YOU HUNTING FOR DATA INSTEAD OF IDENTIFYING OPPORTUNITIES?

The hunt is on. Once again, you're looking for clues as to how, why and where your dollars are flowing. Can you spot your next sourcing opportunity in the accounting reports? If not, you've spotted the need for Spend Management. And also Ariba. We can pull together data from disparate (and often incompatible) sources, help identify savings and transform your business. To learn about Ariba Analysis Solutions, please call 1-866-772-7422. Or visit www.ariba.com/analyze for your free Spend Management Opportunity Assessment.

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PROCUREMENT

SUPPLIERS



WHITMAN eBay's CEO is buying auction sites in India and Korea

Repeat Performers

These managers have shown savvy and a gift for innovation over the long haul

IF ONLY IT COULD BE bottled—that special touch that makes a manager great not just for a quarter, but year after year. In 2004 there were seven we had to take our hat off to once again:

Fujio Cho, 67, president of Toyota Motor Corp., has been smiling a lot these days. And why not? In the U.S., the Camry sedan has dominated car sales for the past eight

years. Suburban moms couldn't get their hands on a Sienna minivan fast enough. And Toyota again deftly paired sales of gas-guzzling Tundra trucks with the environmentally friendly Prius. Analysts expect Toyota to haul in \$11 billion in earnings for 2004.

Carlos Ghosn, 50, has had to steer Nissan Motor Co. past a few more curves. Near bankruptcy in 1999, Nissan

has climbed back under Ghosn to the point where it boasts the car industry's highest operating profit margins: 11%. The CEO's obsession with setting and meeting targets helped, as did fresh new models.

In the 24 years since **Steven P. Jobs**, 49, founded Apple Computer Inc., he has become as famous for his love of good design as for a stubborn insistence on doing things his way. Both traits helped Apple flourish in 2004. Roaring sales of Apple's breakthrough iPod music player—plus an expected \$250 million in U.S. box-office sales for his separate company Pixar Animation Studios' latest hit, *The Incredibles*—show Jobs still knows how to cater to consumers.

For **Margaret C. Whitman**, 48, CEO of eBay Inc., the key to surviving the dot-com ups and downs has been savvy management of a workforce

she does not control: eBay's 125 million registered users. Whitman has a soft touch, constantly talking to buyers and sellers and signing autographs at eBay's annual member conference. Now facing growing competition at home from Amazon.com Inc. and Google Inc., she is extending that touch around the globe, acquiring auction sites in China, India, and Korea, as well as online classified-ad sites.

Terry S. Semel, 61, CEO of Yahoo! Inc., also kept up his company's hot growth by continuing a steady stream of acquisitions in 2004. Early in the year he paid \$160 million for online music service Musicmatch Inc., hoping to bring more subscribers into the Yahoo fold. It's a measure on which Semel has already delivered: Yahoo has more than tripled its number of paying subscribers, from 2 million in 2002 to roughly 10 million today. That, plus a boom in search ads, is expected to nearly double 2004 profits, to \$466 million.

It was as a cost-cutter that **Yun Jong Yong**, 60, initially made his mark. Now the CEO of Samsung Electronics Co. is all about innovation, and he's making waves again. Today Samsung competes with Intel Corp. for leadership in flash memory chips and is threatening Nokia Co.'s cell phone dominance with its advanced mobile devices. Analysts believe Samsung will almost double its profits in 2004, to \$10 billion.

George David, 62, CEO of United Technologies Corp. has turned Carrier air conditioners, Otis elevator and Hamilton Sundstrand aerospace systems into industry leaders. He has regularly delivered double-digit annual earnings growth. And stock returns are up about 650% since David took over in April, 1994. That makes him one of a select group of CEOs who have earned kudos time and again. ■

Revenge of the Rust Belt

Old-line manufacturers are humming as demand soars for commodities

WHEN Wilbur L. Ross Jr. began poking around the steel industry three years ago for cheap assets to buy, the financier had the market pretty much to himself. For good reason: Why would anyone want a talking relic of America's industrial past? Looks as if Ross got the last laugh, though. In late October, he signed a deal to sell the once-bankrupt properties, revived International Steel Group Inc., to steel tycoon **Lakshmi N. Mittal** for \$4.5 billion, pocketing \$300 million for himself. "I always wanted to be a paleontologist as a kid," Ross deadpans. "I love dinosaurs."

So do a lot of other people nowadays. For the past several years, old-line manufacturers were almost universally written off, as investors flocked to Internet stocks and then to nearly anything else—while a global recession and falling commodity prices sucked the life out of the industrial sector. Now, these boring hemophages are raking it in, enriching shareholders who were black by them. China's red-hot economy, which can't seem to get enough industrial commodities, is one reason for their comeback, of course. Demand is strengthening in the U.S., too, and that is pushing many plants to capacity. Indeed, at many

chairman and chief executive of Exxon Mobil Corp., is sitting on \$16.1 billion in cash, with \$14 million being added every day.

Being hot, as Caterpillar Inc. Chairman and CEO **James W. Owens** can tell you, also makes it a lot easier to hit the numbers. Back in 1998, his predecessors set a goal of turning the heavy-equipment and engine maker into a \$30 billion outfit in the

such as ISG and U.S. Steel Corp. are profiting because of demand from the likes of Caterpillar. Caterpillar, in turn, is profiting because of demand from Peabody Energy Corp. and other coal miners. And they, in turn, are profiting from American Electric Power Co., whose generators are gobbling up coal to meet demand from its busy industrial customers. "We're kind of like Mark Twain—somebody called us dead before we were," says **Michael G. Morris**, AEP's chairman and CEO.

From the outside, the extraordinary performance of these mundane goods-makers might look easy. These are, of course, cyclical industries, so it's typical for them to come roaring back after a recession. But management deserves credit, too. Dow Chemical Co., for example, has closed or sold off dozens of inefficient plants and eliminated 7,000 jobs, or 14% of its global payroll, in the past two years. That helped lift utilization rates to over 90% in 2004, giving it leverage to jack up prices. "Productivity is in our DNA," says CEO **Andrew N. Liveris**. Investors got their cut: Dow's share price was up 22% through late December.

These highfliers will eventually drift back to earth. But after being dismissed for so long, many heavy-industry execs can't resist crowing a bit. "For most of us who had to earn money the hard way, we could never figure out this New Economy talk," says **W. James Farrell**, chairman and CEO of Illinois Tool Works Inc., a conglomerate that recorded 30% earnings growth, to \$1.3 billion, last year. "There is some satisfaction in the role reversal." ITW is admittedly unexciting: It makes stuff like strapping bands, plastic rings for beverage six-packs, screws, and switches. But these days, nothing pays like being dull.



ROSS
Pocketed
\$300 million
in a steel deal

manufacturers today, the biggest issue for management is dealing with growth: training new employees after a long hiring drought, offsetting or passing along higher material costs, and ramping up capital spending for expansion. At others, it's simply what to do with the sudden embarrassment of riches. For instance, **Lee R. Raymond**,

next 10 years. But after four years of sales stuck at \$20 billion, management quietly pushed its target date out to 2009 or later. Now, with orders pouring in as fast as the company can fill them, Owens says Caterpillar will easily top the \$30 billion mark in 2005.

All that growth, in fact, is fueling a perpetual-motion machine of sorts. Steelmakers

“I always wanted to be a paleontologist as a kid. I love dinosaurs.”

—Wilbur L. Ross Jr., International Steel Group chairman, who has agreed to sell the company to Lakshmi Mittal

The Bush Team

Its record ranges from masterful campaign to serious miscalculations

BEST: KARL ROVE

The White House

JUDGING BY HIS JOB TITLE, senior adviser to the President, Karl Rove doesn't seem to be a manager of very much. But in reality this 54-year-old college dropout, dubbed "Bush's Brain" by biographers, was the chief executive of a hugely successful enterprise that delivered more votes for a Presidential candidate than any other in U.S. history.

Directing the 2004

reelection effort from the West Wing office once used by Hillary Clinton, the visionary behind George W. Bush Inc. developed an audacious strategic plan that disproved two political axioms: that high-turnout elections favor Democrats and that the candidate favored by most independent voters wins. How did Rove manage to turn history on its head? While Democrats were boasting of record



registration of urban minorities and young people, Rove was methodically employing state-of-the-art technologies to identify and then deliver to the polls millions of social conservatives in rural areas and, most important, in fast-growing "exurbs" such as Warren County, Ohio.

While Rove concentrated on the big picture, his management team handled

day-to-day operations. Campaign manager Ken Mehlman adapted the peer-to-peer business model used by Amway Corp. to enlist neighbors, church friends, fellow veterans, and gun-club buddies. And Republican National Committee Chairman Ed Gillespie made sure that state parties were awash in cash helping to cement GOP gains in House, Senate, and governors' races.

For his efforts, Rove won the ultimate sign of endearment from the President: a new nickname "The Architect." Not bad for someone who had never managed anything bigger than an Austin political firm before he hooked up with the man who made him famous.

WORST: DONALD RUMSFELD

Pentagon

EVEN MANY conservatives who backed President Bush's invasion of Iraq think the Administration has botched the war. And that happened on Defense Secretary Donald H. Rumsfeld's watch. While Rumsfeld had plenty of company in thinking that former Iraqi strongman Saddam Hussein possessed weapons of mass destruction, and Rumsfeld was right that the U.S. could defeat Iraq's army with fewer troops than were deployed in Desert Storm, critics say he miscalculated the resources needed to win the peace. The price: more than 1,300 American deaths so far, thousands more injured, and

a price tag sure to exceed \$200 billion.

The Pentagon chief believed he could turn the keys to the country over to Iraqi exiles and slash the size of the U.S. force to 50,000

fairly quickly. But the number of troops in Iraq keeps growing, with a temporary increase announced on Dec. 1 raising the total to 150,000. Rumsfeld also dismissed State Dept. studies outlining ways to reform such Iraqi institutions as schools and hospitals. Responds Pentagon spokesman Lawrence Di Rita: "The

editors of *BusinessWeek* obviously think they know more than the military commanders on the ground in Iraq, who have received every force level they have sought and have been satisfied every step of the way."

But experts say the conduct of the war wasn't Rumsfeld's only dubious call. He came into office arguing for a smaller, lighter military. Critics say Iraq shows that the U.S. in fact needs a large Army and heavy armor for close combat in places such as Fallujah. And he displayed a less-than-deft touch when he rejected responsibility for sending ill-equipped soldiers into battle, and told troops in Kuwait: "You can have all the armor in the world on a tank and a tank can be blown up." Rumsfeld, however, has managed to hold on to his job despite his performance.



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The Cleanup Crew

Can these five executives bring their companies back from scandal?

AFTER THE DUST settles on a big corporate scandal, someone has to clean up the mess. These five execs are trying to make the best of what their infamous predecessors left behind.

Perhaps it's fitting that **Susan Lyne**, the woman who championed *Desperate Housewives* on ABC, should be charged with helping the queen of homemakers revive her company. Lyne, 54, was named chief executive of Martha Stewart Living Omnimedia in November. With her experience as president of ABC Entertainment, managing editor of New York's *The Village Voice*, and founder of *Premiere* magazine, Lyne has strong creative credentials. But she'll face a challenge building the company's merchandising business, an area she knows little about. And Lyne will have to forge a close partnership with **Stewart** while also trying to diversify the company. The domestic diva is serving a five-month jail sentence for lying to investigators about her trading of ImClone Systems Inc. stock but has vowed to make a comeback.

At ImClone, meanwhile, CEO

Daniel S. Lynch has been working hard to get his tarnished company back on track. Lynch, formerly the chief financial officer, took over in April, 2004, following the controversies that engulfed Stewart and now-jailed ImClone founder **Sam Waksal**. Erbitux, ImClone's delayed colon cancer drug, finally won Food & Drug Administration approval in February and has been selling briskly. The company plans to seek FDA approval in 2005 to market the drug for cancers of the head and neck. And ImClone will also move two other cancer drugs into clinical trials. The results will determine whether Lynch, 46, can keep ImClone on its recovery path.

The CEO-elect at software maker Computer Associates International Inc., **John Swainson**, is facing a different challenge. A 26-year veteran of IBM, Swainson, 50, must rebuild CA's credibility, which waned after former CEO **Sanjay Kumar** was indicted in

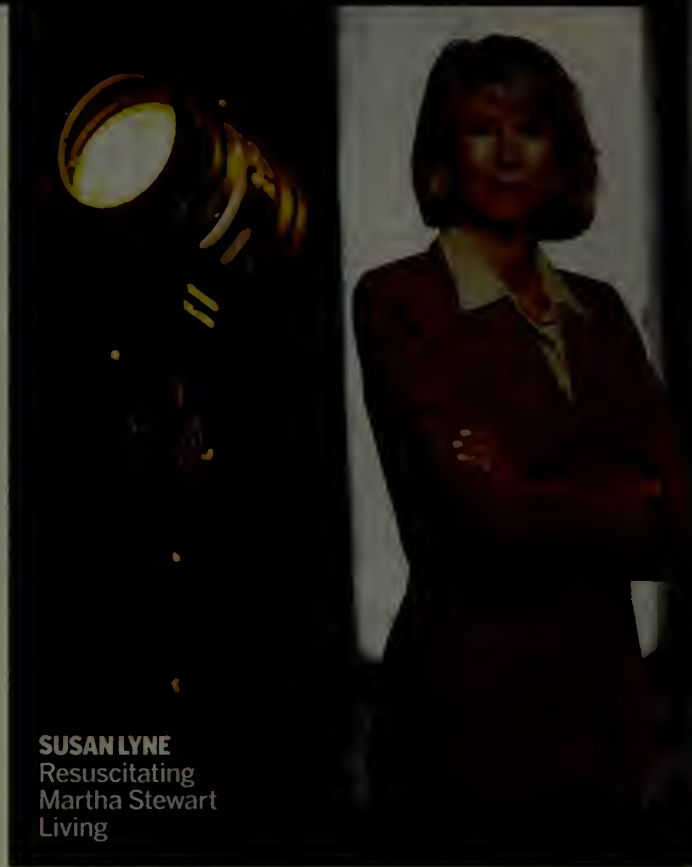
September on charges of securities fraud and obstruction of justice. He denies the charges. Swainson built IBM's WebSphere line of products—which run large computing systems—from revenues of zero in 1998 to \$1 billion last year. When he takes over as CA's CEO early this year, he'll be under pressure to pull off a similar miracle.

HealthSouth Corp. CEO **Jay Grinney**, 53, has enjoyed some good news of late. The rehabilitation hospital chain, burdened by a \$2.7 billion accounting scandal and the looming trial of founder **Richard M. Scrushy**, will still generate \$630 million in earnings in 2004 on sales of \$4 billion. Grinney intends to

boost profits even more this year by, among other things, updating the chain's inefficient computer system. Admits Grinney: "Paying for the sins of the past is a process. We are six months into a three-to-four-year fix."

Whatever happened to Enron Corp.? **Stephen F. Cooper**, 58, who was brought in January, 2002, as interim CEO, has overseen the sale and restructuring of some \$12.65 billion worth of the Houston energy giant's assets. Among his deals: the pending sale of Oregon utility Portland General Electric Co. for about \$2.35 billion in cash and assumed debt. Once the sale closes and outstanding claims are resolved, Enron, which emerged from bankruptcy in November, will distribute some \$12 billion to creditors—far less than the \$63 billion they claimed they were owed. Individual shareholders will get nothing. But Cooper and his turnaround company, Kroll Zolfo Cooper Inc., will have pocketed at least \$63.4 million in fees. Cleanup: It's not always a thankless task.

SUSAN LYNE
Resuscitating
Martha Stewart
Living



“Paying for the sins of the past is a process. We are six months into a three- to four-year fix.”

—**Jay Grinney**, new CEO of HealthSouth Corp., which has been rocked by an accounting scandal involving former chief Richard Scrushy

The Worst Managers

Any exec can make a bad situation worse. It takes a certain breed to make it a near catastrophe

RAYMOND GILMARTIN

Merck

NO DOUBT MERCK & Co. Chairman and CEO Raymond V. Gilmartin would prefer to forget 2004, when the drugmaker had to withdraw Vioxx—its painkiller that was hauling in \$2.5 billion in

annual sales. But while last year was tough, Merck will be paying the price for the Vioxx disaster for years to come.

Although critics had been warning for years that Vioxx might be dangerous, Gilmartin and his team had

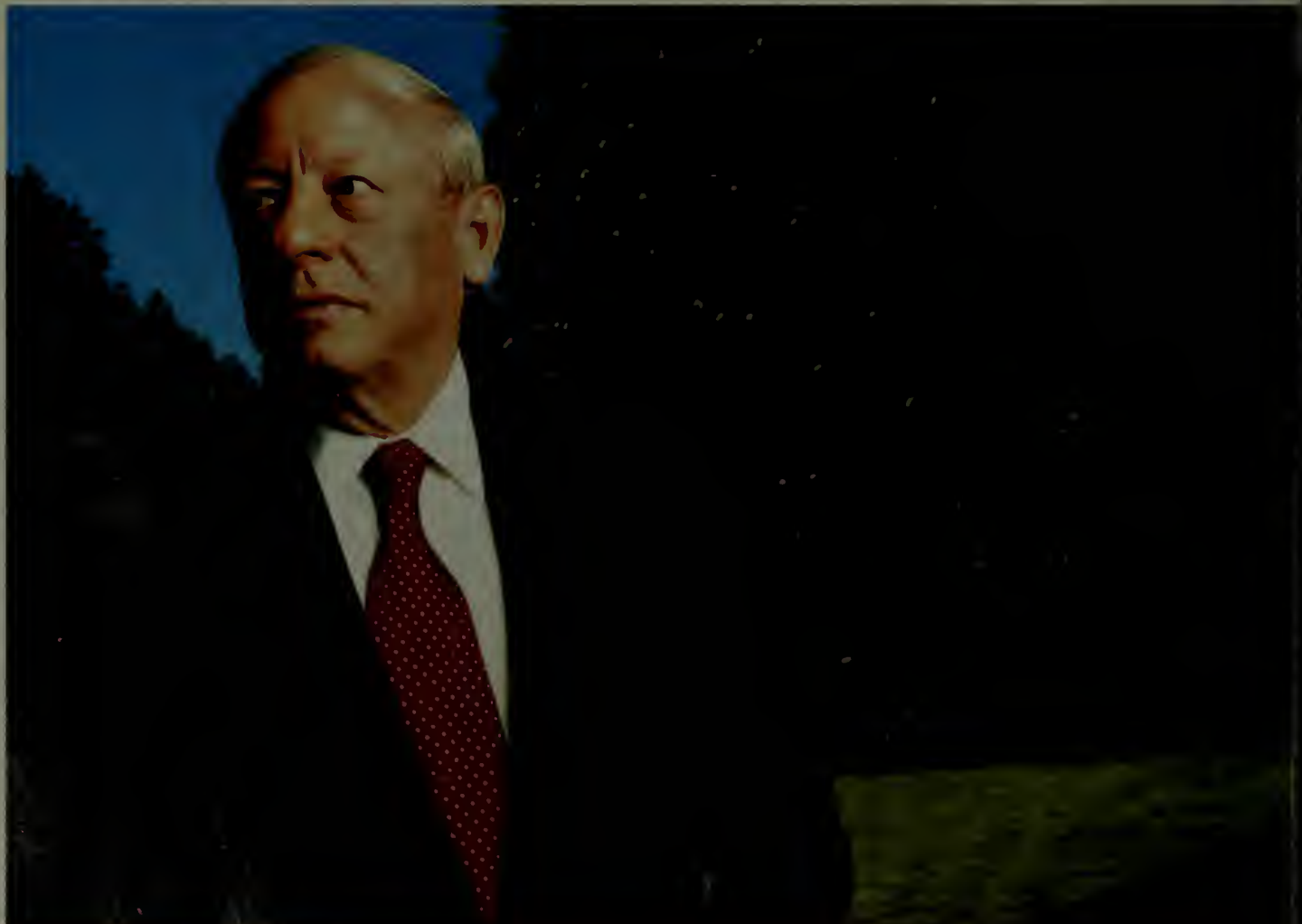
argued the drug was safe, and they continued to promote it aggressively. But in late September, a Merck study confirmed the drug raised the risk of heart attack and stroke. Merck is facing hundreds of lawsuits over Vioxx and is likely to get hit with many more. Sanford C. Bernstein & Co. analyst Richard T. Evans warns that the legal liability could exceed \$25 billion.

A bill that high will limit Merck's financial flexibility. While Gilmartin has stepped up the pace of licensing and product acquisition—striking about 50 licensing deals in 2004, up from just 10 in 1999—it may be too little, too late. In 2006 the company will lose U.S. patent protection on its \$5 billion cholesterol-lowering drug Zocor. And while Merck has some interesting products in its pipeline, they're unlikely to be large enough to offset the loss. No wonder Merck's

stock is off about 30% since the Vioxx withdrawal.

Gilmartin has also resisted the industry trend drug-company megamergers. While there is no evidence those deals improve research and development productivity, they do offer cost savings opportunities and new products to help companies manage through lean times. And while Merck could have done a deal years ago from a position of strength, its weak stock price and likely huge legal liability now make it an unattractive partner.

With the 63-year-old Gilmartin preparing to retire in the spring of 2006, Merck's board has started searching for his replacement. Some disgruntled investors would like to see Gilmartin step down early. But in the wake of the mess, directors may struggle to recruit someone to fix the ailing drugmaker.



DAVID SMITH

Sinclair Broadcast Group

IN THE RUNUP TO THE Presidential election, Sinclair Broadcast Group c. CEO David D. Smith came the bogeyman of Big media. Allegations surfaced in October that Sinclair planned to broadcast the anti-Kerry documentary *Stolen Honor* to its 62 TV stations across the country. Liberal groups were livid, arguing that longtime GOP contributor Smith, 54, was trying to influence the election. Media watchdogs also made Sinclair Exhibit A in their argument against the spread of media consolidation. With the nation's media concentrated in fewer hands, they say, owners can more easily skew news coverage to their political views. Indeed, Smith's aggressive style could hamper Sinclair's

attempts to consolidate multiple stations in various markets. Over the years, Smith challenged federal rules restricting the number of TV stations a company can own in a market. In the meantime, he set up partnerships with other stations in his markets, till regulators loosened the rules to allow companies to own at least two stations in many locales.

The flap over *Stolen Honor* isn't the first time Smith has been accused of editorial manhandling. Earlier this year, Sinclair refused to air a *Nightline* episode in which anchor Ted Koppel read the names of U.S. war dead in Iraq. Sinclair defends its right to preempt network shows unsuited to the tastes of local audiences. As for *Stolen Honor*, Smith denied any



intent to turn the election, saying he wanted only to champion free speech. And the company says it never planned to run the film in its entirety. On Oct. 22, Sinclair ran excerpts as part of a special *A POW Story: Politics, Pressure, and the Media*.

Sinclair's stock fell 17%, to

\$6.26, over the 11 days of controversy. It has regained that ground, though the price was still down 39% in late December from a year earlier. But even if Sinclair recovers financially, Smith's dip into the partisan pool is sure to come up the next time he needs clearance for expansion.

FRANKLIN RAINES

Fannie Mae

ON LABOR DAY, HE WAS a favorite to be Treasury Secretary should John Kerry win the White House. At yearend, he left under a cloud. The famed career of Franklin D. Raines—a poor kid from a small town who climbed through Harvard and a Rhodes Scholarship to become White House budget director and CEO of Fannie Mae—crashed to a halt on Dec. 21. That was 11 days after the Securities and Exchange Commission's top accountant declared that mortgage giant Fannie Mae overstated earnings for 3½ years, leading to an estimated \$1 billion restatement that would wipe out 40% of profits from 2001 to mid-2004. Supporters of Raines, 55, insisted that he wasn't responsible for Fannie's misuse

of obscure accounting standards. But that argument didn't wash. Raines was in charge in 2001, when Fannie chose to create what the SEC dryly called "its own unique methodology" to calculate the

earnings impact of its trillion-dollar portfolio of derivatives. Raines gave Chief Financial Officer J. Timothy Howard free rein and tolerated "weak or nonexistent" financial controls, according to a scathing report issued in September by the Office of Federal Housing Enterprise Oversight, Fannie's regulator.

Worse, the CEO failed to

manage the scandal. When sibling Freddie Mac's accounting first came under fire in mid-2003, Raines's arrogant insistence that Fannie was above reproach spurred OFHEO to do a white-glove examination. And when that uncovered the improper bookkeeping, Raines insisted on an SEC review, which he maintained would vindicate Fannie. "Frank was supposed to be the great political risk manager," says independent banking analyst Bert Ely in Alexandria, Va. "Instead, he compounded the problems."

When Fannie's board balked over ousting Raines, OFHEO forced its hand. Raines described his exit as an "early retirement" that was self-initiated and says that it shows he was accountable for the SEC findings. Fittingly, Raines—a man who built a \$54 billion behemoth with his mastery of behind-the-scenes politicking—went down spinning.



WORST MANAGERS

MICHAEL EISNER

Walt Disney

IT HASN'T BEEN A supercalifragilistic year for Michael D. Eisner. The 62-year-old Walt Disney Co. CEO weathered a hostile takeover attempt in February, and a month later he was stripped of his chairmanship following a 45% no-confidence vote by shareholders. The year ended with a public airing of management missteps in the 1996 firing of President Michael Ovitz. And before Eisner left for the holidays, Disney settled SEC charges that it failed to disclose transactions between the company and its board members from 1999 through 2001. Disney admitted no wrongdoing.

After a yearlong battle with Walt's nephew Roy Disney, Eisner is retiring in 2006, when his contract expires. President Robert A. Iger is the

only internal candidate to succeed him—which “shows how weak a bench Eisner had,” according to Greg Taxis, CEO of shareholder advisory firm Glass Lewis & Co. Whoever inherits the job will no doubt try to lure back

blockbuster maker Pixar Animation Studios, whose chairman, Steve P. Jobs, battled with Eisner. Pixar's last film for Disney will be *Cars* in 2006.

Oddly enough, Eisner's departure comes as Disney appears to be on the mend.

After six years of lackluster earnings, profits rose 64% in 2004. The stock climbed over the past year. Still, the only brings it back to 1999 levels. The Head Mouseketeer will be leaving the stage without much applause.



GARY BETTMAN

National Hockey League

ARENAS HAVE BEEN empty since Sept. 15, when National Hockey League owners locked out the players. NHL finances are in shambles, and the weak TV deal signed with NBC last spring suggests the league has little leverage and is now a second-tier sport. But say this for Commissioner Gary Bettman: He finally has owners marching in lockstep toward a tough new contract—even if their unanimity is about a decade too late.

Under Bettman, the NHL has been skating on thin ice for years. Even though its revenues hit \$2.1 billion last season, the league claims 20

of 30 franchises lost money, and that it lost a total of \$225 million. Salaries zoomed to 75% of league revenues last season, from 41% in 1990-1991, the NHL says. That outstrips the share of revenues going to players in

pro football (64%) and basketball (57%).

NHL owners, an undisciplined bunch, should shoulder much of the blame for wildly bidding up salaries. But little prudence has been shown by NHL Players Assn. chief Bob Goodenow, who might have been wise to heed Bettman's warnings that the unsustainable rate of salary growth was undermining the

business on which players depend for their livelihood. In 1994 talks, Goodenow successfully resisted Bettman's efforts to ram through the sort of salary cap that is supposed to keep NHL and NBA payrolls in check. After a 103-day lockout, the Commish backed down, and the NHL accepted a watered-down plan that didn't do much to slow the pay spiral.

This time Bettman and owners vow to hang tough, and the union's Dec. 9 offer to roll back salaries seems to reflect a recognition that league-threatening problems exist. If the league holds its ground and wins a salary cap—or even settles for a hefty rollback—Bettman could end up looking like a shrewd crisis manager. But it was a crisis that should never have happened.



SCOTT LIVENGOOD

Krispy Kreme

SCOTT A. LIVENGOOD loves to wax about the "brand mythology" that has built up around Krispy Kreme Doughnuts Inc., which enjoys a cult-like following. But investors, once enthralled with KK's soaring profits andiddy over its stock price, may see it as a kind of corporate Icarus, crashing to earth. After a heady rise following its 2000 initial public offering, Krispy Kreme's shares have plunged roughly 80% from their peak. And the Securities & Exchange Commission has launched an inquiry into whether the North Carolina-based chain used improper accounting to prop up its earnings, which are now on

the decline. The company says it's cooperating with the SEC.

While Livengood blames the doughnut chain's woes on the low-carb craze, critics counter that rival Dunkin' Donuts Inc. doesn't seem to be suffering any similar effects. The real problem, critics contend, is that Livengood expanded too fast after the IPO, saturating some markets with so many stores that the brand quickly lost its novelty. The company is also being dogged by questions over how it accounted for the buyout of franchisees, as well as accusations of self-dealing in its buyback of some franchises owned by corporate insiders. A group of



shareholders filed suit earlier this year after learning that Krispy Kreme paid a hefty premium to reacquire a franchise partially owned by Livengood's ex-wife.

Livengood still believes he can reinvigorate sales, by

rolling out smaller stores and new products such as a sugar-free doughnut. The company says he is "laying the groundwork for long-term, sustained growth." But it will take a lot to restore Krispy Kreme's luster.

HOWARD PIEN

Chiron

THE DEFINING IMAGE of Howard H. Pien's horrible year is no doubt the crowds of elderly Americans camped out for hours at clinics, trying desperately to get their annual flu shots. Many of them were never vaccinated, because Chiron Corp.—one of only two major flu vaccine providers—was prohibited from releasing doses produced at the Liverpool (England) plant that makes the treatment. British regulators suspended the plant's license in October, citing contamination problems, and Pien had to apologize for failing to provide any vaccine to U.S. patients.

Pien hoped the flu would be Chiron's ticket to the pharmaceutical big leagues. In 2003, just months after he was named chief executive of the 23-year-old

Emeryville (Calif.) company, Chiron acquired British vaccine maker PowderJect Pharmaceuticals PLC and increased the efficiency of its Liverpool plant, helping it to

make 50% more flu vaccine than it had the previous year. Pien planned to boost production by an additional 37% this year. He promised to build Chiron into a global powerhouse capable of producing vaccines for a host of illnesses beyond the flu, and he vowed to boost research in potentially more

profitable biotech drugs.

Now critics wonder if Pien dropped the ball on quality. Without the vaccine, Chiron will take an estimated \$300 million hit to its 2004 revenues, finishing the year with \$1.8 billion, analysts predict. Chiron expects to report earnings of no more than \$78.5 million—less than half what it earned in 2003. Chiron's stock has fallen 30% since October, to \$32. The Securities & Exchange Commission has launched an informal probe, and the U.S. Attorney's Office is investigating the company. "We are fighting our way out of this situation with the goal of remediating our facility," Pien says. "We will continue to act responsibly in the service of public health."

In November, Pien told the U.S. House of Representatives that he had a plan to get Chiron back in gear for the 2005-06 flu season. But to sickened patients and investors, that's a long time to wait to see if Pien can keep his promise.



The Fallen Managers

Personality clashes, fraying markets—but these honchos often contributed to their own descent

PHILIP WATTS

Royal Dutch/Shell

THE DEPARTURE OF Philip Watts as chief executive of Royal Dutch/Shell Group on Mar. 3 was a humbling end to what had been a stellar career at the top of the global oil business. Watts resigned at the request of his board after Shell announced on Jan. 9 that it was downgrading the amount of oil and gas it could produce by about 4 billion barrels, or 20%.

Watts seems to have brought about his own downfall. Much of the overbooking of those proven oil reserves occurred from

1997 to mid-2001, when he was exploration and production chief. A Mar. 31 study by New York law firm Davis, Polk & Wardwell revealed that almost from the time Walter van der Vijver succeeded Watts in that role, he had complained to his boss about “aggressive” or “premature” bookings during Watts’s tenure. Watts didn’t call for the investigation that uncovered the problem until late 2003. The news triggered investigations by the Securities & Exchange Commission and other regulators. Shell says that it has an agreement in principle with the SEC to pay \$120 million and to spend \$5 million on compliance. Watts has denied any wrongdoing.

The imbroglio triggered a shakeup of management and governance. Not only was Watts replaced by Jeroen van der Veer as CEO, but van der Vijver and Chief Financial Officer Judith Boynton both lost their jobs (Boynton remains a Shell employee). On Oct. 28, Shell said that it will scrap its unusual dual-company structure. Critics say that it had made Shell too slow-footed to match the moves of its rivals. But it took a crisis to force the change.



(CLOCKWISE FROM TOP) JONATHAN SAUNDERS; JIM YOUNG/REUTERS; MARK RICHARDS; GRAHAM BARCLAY/BLOOMBERG NEWS

SANJAY KUMAR

Computer Associates International

SANJAY KUMAR WAS once the protégé and right-hand man of Computer Associates International Inc. founder Charles B. Wang. The Sri Lankan native took over as CEO in 2000, promising to improve accounting and customer relations. But while customer ties got better, the accounting came under fire. A Justice Dept. probe of CA’s accounting begun nearly three years ago culminated

last September with Kumar being indicted for securities fraud and obstruction of justice. He denies the charges.

The government got its break in the case last January when a midlevel CA manager started cooperating with investigators. Then, one by one, more executives started talking. The government found that at the end of quarters in 2000 and 2001, CA execu-



FRANK DUNN

Nortel

FRANK DUNN WAS chosen to run Nortel Networks Corp. in November, 2001, primarily because its board thought he possessed the financial acumen to lift the Brampton (Ont.) equipment maker out of a quagmire. Amid the telecom industry meltdown, Nortel said it lost \$27.3 billion that year after losing \$3.5 billion in 2000. Dunn had served as chief financial officer since 1999. "We thought Frank was the guy with the right kind of skills," Lynton R. "Red" Wilson, chairman of Nortel's board, told *BusinessWeek* at the time.

Bad assumption. Last April, Wilson and the board booted Dunn from the chief executive's chair after questions emerged about the

very area he was supposed to be such an expert in—accounting. Now several investigations are under way to determine if Dunn cooked the books to generate profits and cash bonuses. A U.S. grand jury has subpoenaed Nortel's financial statements—in addition to personnel and accounting records dating from 2000—as part of a criminal investigation by the U.S.

Attorney's Office for the Northern District of Texas, in Dallas. The Securities & Exchange Commission and

the Royal Canadian Mounted Police are also probing. Dunn declines to comment.

Far from fixing the company, Dunn seemed only to cast it into more turmoil. Nortel is still struggling to restate results from 2000 to 2003, and it may have to cut 2003 earnings by half. In 2004, many analysts expect the company to break even at best.



CRAIG CONWAY

PeopleSoft

WHEN A BOARD OF directors decides to dump a chief executive officer, they usually try to sugarcoat the firing so investors don't hit the panic button. But when the board of software maker PeopleSoft Inc. gave the boot to CEO Craig Conway on Oct. 1, it didn't pull any punches, saying it had "lost confidence" in Conway's leadership. Later, in press interviews and court testimony, PeopleSoft board members said they were worried that Conway had misled investors about the impact of a hostile takeover bid by rival Oracle Corp.

Conway

hasn't publicly commented on what happened. But it's a ignominious way to end his five-year run. The 49-year-old CEO engineered a

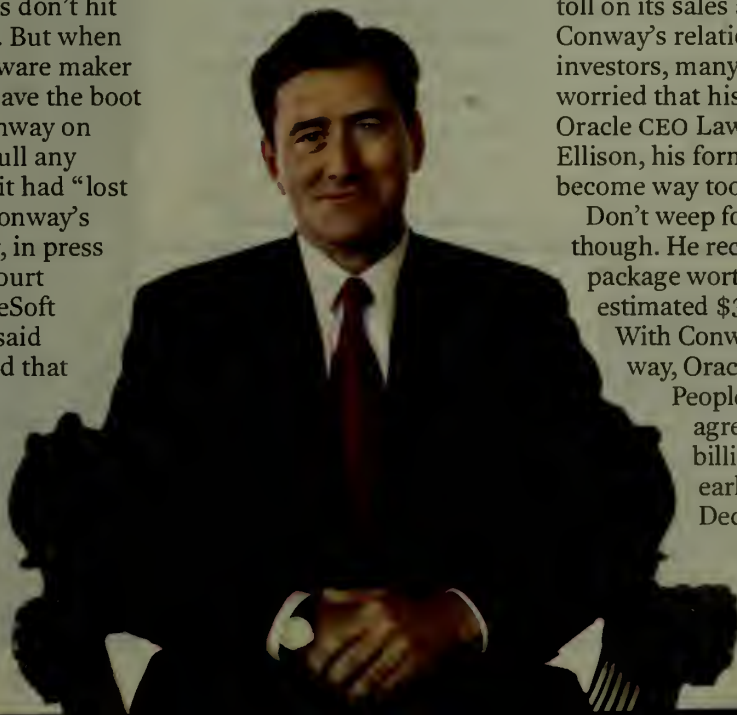
dramatic turnaround at the Pleasanton (Calif.) company and drove it to record sales. But a merger last year with J.D. Edwards & Co. hasn't gone as well as many hoped. Meanwhile, the 18 months the company spent fending off a hostile takeover bid by rival Oracle were taking a toll on its sales and on Conway's relations with investors, many of whom worried that his fight with Oracle CEO Lawrence J. Ellison, his former boss, had become way too personal.

Don't weep for Conway, though. He received an exit package worth an estimated \$3.2 million.

With Conway out of the way, Oracle and

PeopleSoft finally agreed on a \$10 billion deal in the early hours of Dec. 13. It's

expected to close as early as January.



FALLEN MANAGERS



DAVID POTTRUCK

Charles Schwab

WOE TO THE CHIEF executive who manages in the shadow of a legendary founder. That's a lesson David S. Pottruck could teach in his new part-time career as a business-school lecturer. On July 20 the board of Charles Schwab Corp. showed Pottruck the door just 14 months after naming him CEO. Founder, Chairman, and former CEO Charles R. Schwab resumed the post.

During his tenure, Pottruck, 56, failed to reverse the disappointing revenue trends that began plaguing Schwab in 2000 while he and Chuck Schwab were co-CEOs. Also on Pottruck's watch, Schwab completed an ill-advised \$289 million acquisition of Soundview Technology Group Inc. Pottruck accepted responsibility for the company's poor performance in a September, 2004, interview. But many believe Chuck Schwab is partly responsible. "There are things I wish I'd done," he said in October. Schwab said he tried

to give Pottruck "license" as CEO. But as chairman during that period, Schwab weighed in on key decisions. Indeed, when he handed over the full CEO title to Pottruck in 2003, the board amended the company's bylaws to give the chairman an "active role" in setting strategy.

The possibility that Schwab might return to the CEO job hung over Pottruck while he was at the helm. "I never considered Chuck Schwab and myself to be equal," he said in September. The situation is typical of a company where a charismatic founder is still influential, says John Kador, author of *Charles Schwab: How One Company Beat Wall Street and Reinvented the Brokerage Industry*.

Pottruck's \$10 million contract will keep him on Schwab's payroll through 2007. Meanwhile, he has started a private equity firm, Pottruck Group. The right buyout deal could put him back in the CEO role—ideally at a company where the founder has long since retired.

JEFFREY GREENBERG

Marsh & McLennan

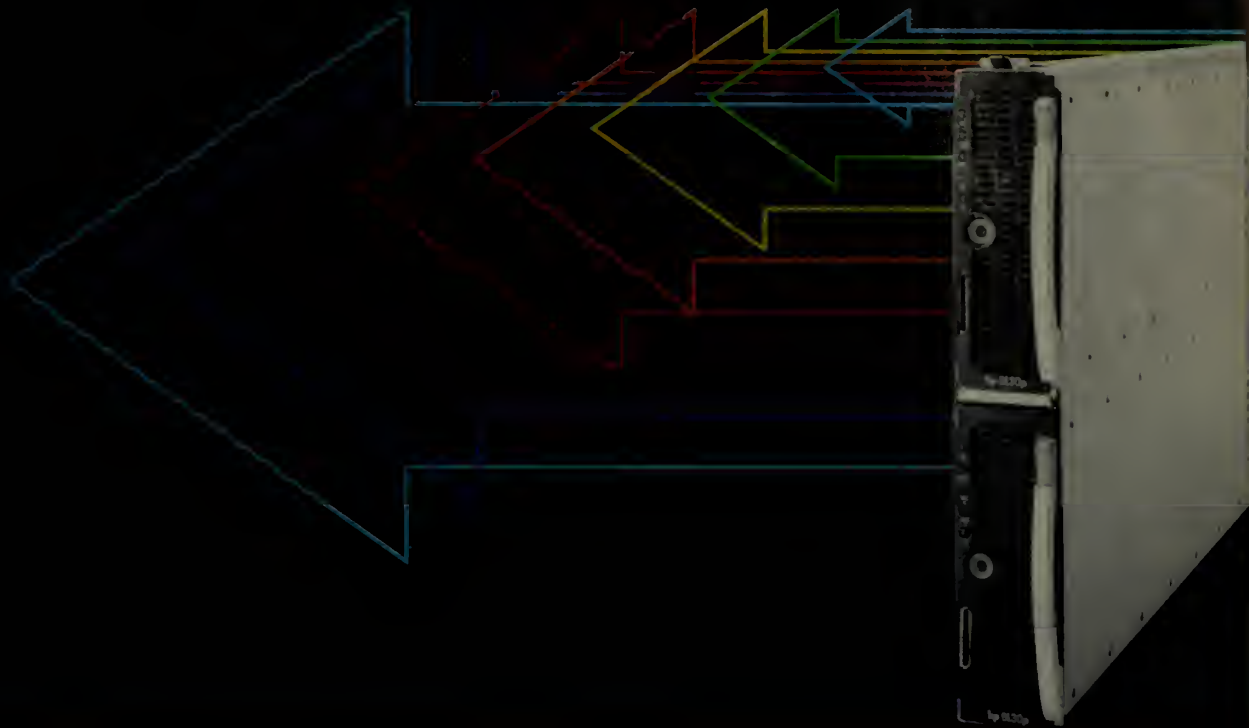
JEFFREY W. GREENBERG spent five years at the helm of Marsh & McLennan Cos. before New York State Attorney General Eliot Spitzer went after the \$12 billion financial-services firm. In mid-October, Spitzer charged the company's insurance-brokerage unit with bid-rigging and accepting kickbacks, among other allegations. Greenberg stepped down on Oct. 25.

It was the last in a long line of blows for Greenberg, 53, a son of American International Group Inc.'s Maurice R. "Hank" Greenberg. Early on in his tenure, almost 300 Marsh Mac employees died in the September 11 attack on the World Trade Center. Two years later, enforcers charged Putnam Investments, a Marsh Mac unit, with securities fraud relating to late trading and market-timing of its funds. In March, 2004, the Securities & Exchange Commission started investigating Mercer, the

firm's pension-consulting arm, for alleged "pay to play" practices—that is, forcing investment managers to pay big fees to get Mercer to recommend them to pension funds. Marsh Mac denies that. Then, just two months later, Mercer admitted it had provided false information to the New York Stock Exchange board about then-Chairman Richard R. Grasso's \$187 million pay package.

Some say Greenberg inherited a mess when he took over in 1999. Even so, Greenberg has been criticized for being a hands-off executive, setting steep financial goals for his lieutenants but not bothering to manage how they met them. Some Marsh Mac division heads say this led to a culture that encouraged some managers to take excessive risk and game the system. But of the players in this spiraling mess, it was clearly Spitzer who administered the *corde de grâce*.





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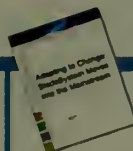
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They Fought The Law

A parade of alleged corporate wrongdoers faced their accusers

JUSTICE CAME CALLING for the criminal defendants of Corporate America in 2004. And after years of battling various charges of bad behavior, some of the most notorious names in business are finally facing their accusers—or paying their dues.

Domestic icon **Martha Stewart** is in a West Virginia

Boston, was handed an 18-month sentence in September after being found guilty of obstructing justice and tampering with witnesses during a government investigation of the bank's activities. Quattrone, who is free pending appeal, was also barred for life from working in the securities industry.

Other high-profile defendants dodged jail time but are heading back to court. One of the most closely watched events is likely to be the retrial of former Tyco International Ltd. CEO **L. Dennis Kozlowski** and ex-Chief Financial Officer **Mark H. Swartz**. Kozlowski became a poster boy for excess—with tales of his \$2 million birthday party and \$6,000 shower

curtain during the pair's last trial, on charges of stealing \$600 million from the company and shareholders. That trial ended in April with a hung jury. A new one

ON THE DOCKET
Martha Stewart
after day one of
jury deliberations



ENRON SAGA Kenneth Lay (seen with wife Linda) will go on trial in Houston

is likely to start early this year. Kozlowski, meanwhile, has to mount a defense against charges of sales-tax evasion on art purchased in New York. Both men deny all charges.

Even Kozlowski, however, might get upstaged by the final act of the long-running Enron Corp. drama. Sometime in 2005, former Chairman **Kenneth L. Lay**, CEO **Jeffery K. Skilling**, and Chief Accounting Officer **Richard A.**

Causey are expected to go on trial in Houston on a variety of criminal charges. They're defended by a platoon of high-priced lawyers—but they'll be facing Justice Department prosecutors who have won jury convictions and negotiated guilty pleas with 15 other Enron managers and advisers involved in the fraud.

So far, the most impressive scalp collected by prosecutors belongs to ex-Chief Financial Officer **Andrew**

Meanwhile, **Frank P.**

Quattrone, the former star tech banker at Credit Suisse First

“I am innocent of the accusations against me and have been blessed by the Lord in having the resources to confront my accusers.”

—Richard Scrushy, former CEO of HealthSouth, who could be sentenced to more than 450 years in prison

stow. He pleaded guilty to securities and wire fraud early last year. Fastow is expected to begin a 10-year sentence later this year—after his wife, Lea, who is currently serving a one-year term, leaves prison. The Task Force's decision to prosecute a Fastow certainly helped put pressure on her husband to cut a deal, and there has been some speculation that the feds may try the same trick with Lay. His wife, Linda, participates in a family charity that sold stock when Enron was plummeting, and therefore she might be vulnerable to insider-trading charges. She denies wrongdoing, as do Lay, Skilling, and Causey. But few alleged wrongdoers have been as thorough in mounting their defense as **Richard M. Scrushy**,

former CEO of HealthSouth Corp. Since being indicted in October, 2003, on 85 counts of fraud—since reduced to 58—for which he could conceivably be sentenced to 450 years behind bars, Scrushy has mounted a furious public-relations and legal blitzkrieg. Among other things, Scrushy now funds his own TV talk show—*ViewPoint with Richard and Leslie Scrushy*—and has filed a formal complaint against the local U.S. Attorney, an FBI agent, and a Justice Dept. official, alleging they withheld evidence that would help exonerate him. He told *BusinessWeek*: “I am innocent of the accusations against me and

have been blessed by the Lord in having the resources to confront my accusers.”

Still, it will take more than good ratings and a fat wallet to battle the charges that Scrushy led a \$2.7 billion conspiracy to inflate earnings and asset values at HealthSouth. A special audit review committee reported in July that they had found 20 fake bank accounts through which HealthSouth overstated cash balances by at least \$373 million. Scrushy claims that five former CFOs and a bevy of accounting officials led the conspiracy. With religion, money, executive ego, politics, and betrayal expected to rear their heads, a Scrushy trial is certain to be a spectacle.

A more subdued but equally determined defendant is **Bernard J. Ebbers**, former CEO of WorldCom Inc., who was indicted in March on charges of conspiracy, securities fraud, and making false regulatory filings. Prosecutors allege he was the ringleader in an \$11 billion accounting fraud, the largest in U.S. history. The indictment says Ebbers “knowingly and consistently” manipulated financial results to please Wall Street, although the former motel-chain operator denies wrongdoing. The prosecution's star witness is expected to be **Scott D. Sullivan**, WorldCom's former finance chief, who has pleaded guilty in the case and is cooperating with prosecutors. The trial is expected to kick off in January in New York.

The scandal parade isn't exclusively American. Canadian

HEALTHSOUTH Richard Scrushy is fighting 58 counts of fraud

media baron and former Hollinger chief **Conrad Black** is facing a Securities & Exchange Commission probe, shareholder suits, and other investigations for allegedly defrauding investors and looting his company. Black is fighting the allegations and trying to take Hollinger private.

Meanwhile, former



CANADIAN SCANDAL Conrad Black is charged with looting Hollinger

Parmalat CEO **Calisto Tanzi** of Italy spent 2004 fighting the law. He denies prosecutors' charges of market-rigging, falsifying accounts and obstructing the Italian stock market regulator Consob. Tanzi is now awaiting trial on those charges after having confessed to siphoning off \$665 million from the \$7.2 billion milk giant to a family-owned travel company. Parmalat was found to have \$18 billion missing from its accounts early last year, making it one of the biggest corporate frauds in history. A slew of criminal and civil trials is set to get underway this year involving Tanzi and other top Parmalat execs, banks, auditing companies, and others. Tanzi, who suffers from ill health and is now under house arrest, faces up to 15 years in prison if convicted.

It all adds up to a full year of courtroom drama—and, for those shareholders burned by Enron, Tyco, and the other corporate debacles, perhaps a smidgen of justice.



(CLOCKWISE FROM LEFT) JAMES NIELSEN/ZUMA/CORBIS; BEBETO MATTHEWS/AP/WIDE WORLD; BRADLEY C. BOWER/AP/WIDE WORLD; GARY TRAMONTINA/REUTERS



Succession Screw-ups

It matters how companies pick—or don't pick—their next boss

THE DEATH OR illness of a chief executive is a crisis most companies rarely face. But McDonald's Corp. did so twice in just seven months in what was widely viewed as a model of succession planning. When **James R. Cantalupo** died of a heart attack in April, the board within hours appointed his second-in-command, **Charles H. Bell**, who had been groomed for the job. And when Bell

resigned on Nov. 22, after being diagnosed with colon cancer, the board named Vice-Chairman **James A. Skinner** to the job. Leaving nothing to chance, it promoted U.S. operations chief **Michael J. Roberts** to president and chief operating officer, in line to succeed Skinner, 60.

Unfortunately, McDonald's is the exception. Last year brought several pointed reminders

of how few top execs prepare for an orderly transition—and how many lack qualified successors. At Walt Disney Co., for example, the board has only one internal candidate to succeed **Michael D. Eisner**—and has gone outside to find others. And at Charles Schwab Corp., the transition from CEO **Charles R. Schwab** to **David S. Pottruck** ended with all the grace of an 18-car pileup.

But on the subject of succession, those two look like role models compared with insurance giant American International Group Inc., whose aging CEO has no plans to retire.

“If I were associated with that search, I would be embarrassed.”

—Executive recruiter **Joseph D. Goodwin**, about Coca-Cola's failure to recruit a top CEO from the outside

GREENBERG
No sign of leaving AIG

Maurice R. “Hank” Greenberg, who turns

in May, groomed two sons to be successors, but both have since left AIG.

Greenberg Sr. then created an office of the chairman in 2002, which includes co-COOs **Martin J. Sullivan** and **Donald P. Kanak**. Both are considered possible successors, but the board won't know Greenberg's preference until his departure, when it opens a sealed letter. Robert E. Hallagan, vice-chairman of search firm Heidrick & Struggles International Inc., argues the board should be managing the process, not Greenberg. Says Hallagan, “That's breaking just about every rule in the book.”

Succession woes also continued to dog Coca-Cola Co. Former CEO **Douglas M. Daft** has said he told the board in 1999 that he planned to serve five years, yet the board had no successor in place. The only internal candidate, President **Steven J. Heyer**, lost board support and later left to become CEO of Starwood Hotels & Resorts Worldwide Inc. The search for outside help was marred by press leaks that prompted several candidates to drop out. In the end, the board chose retired Coke executive **E. Neville Isah**. As executive recruiter **Joseph D. Goodwin** said at the time: “If I were associated with that search, I would be embarrassed.”

Harsh words. But when it comes to botched succession, Coca-Cola can take consolation in one thing: It's not alone.

Exploring Life



Fulfilling Dreams

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HealthCare CropScience MaterialScience

The New Bayer

It's Trump's World

An uneven business record, but his mythmaking ability is unprecedented

ENRON CORP.'S collapse and the deflating of the dot-com bubble led many to predict the demise of the "Celebrity CEO." If only they had known: Waiting in the wings was the High Priest of Hype, Donald J. Trump. A master at hawking his own brand, Trump, 58, discovered reality TV and used it to become the best-recognized and possibly most celebrated chief executive in America. The hoopla surrounding his tube persona was all the more amazing considering that, back in the real world, Trump Hotels & Casino Resorts Inc. filed for bankruptcy on Nov. 21 and has long had a poor-performing stock. Ever the optimist, Trump calls the move a success. "I'm restructuring the debt," he says, asserting that the casinos account for less than 1%

of his total net worth.

Indeed, Trump the icon has become a national phenomenon. As many as 41.5 million people have tuned in to his hit TV show, *The*

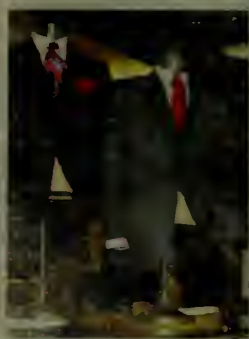
Apprentice. His new line of \$500 suits is a top-seller at Macy's, while his \$60 men's fragrance has broken sales records at Marshall Field's. Meanwhile, he has cranked out best-selling books, a new board game, magazines—even a 12-inch doll that spouts such Trumpisms as "You're Fired." The biography on *The Apprentice* Web site calls him "the archetypal businessman—a deal-maker without peer and an ardent philanthropist."

Such hyperbole might make the average human blush, but not Trump. He tries to be modest about himself in conversation, but his enthusiasm for all things

Trump soon bubbles over. "This has become the

best brand," he says. Although he prides himself first as a builder of top-notch properties, he has long recognized the power of in building up his largely private real estate empire. The son of developer Fred Trump, The Donald became famous for his relentless promotion. It has paid off. New York, analysts say that the name Trump instantly commands a 25% premium on the apartments he develops—even as the ostentatious structures inspire the wrath of some neighbors. Other developers pay him millions to put his name on their buildings, and his company is now flooded with licensing offers, including one for an upscale Trump casket (he declined).

Perhaps it's fitting that a brash, flawed entrepreneur should be the hero of working Americans. At a time when rival billionaires drive jeeps and wear blue jeans, Trump vindicates gaudy wealth. While others may bemoan corporate corruption, Trump glorifies business as an almost heroic pursuit. Indeed, he argues that *The Apprentice* celebrates business itself. "Nobody thought a show based on business would ever work except perhaps on CNBC," says Trump. "But people can't get enough of it." For millions of TV viewers and readers of his books, Trump personifies the savvy businessman many aspire to be—including, perhaps, Trump himself.



TRUMP CLOTHES Do they make the man? Macy's bets you'll think so



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Industry Outlook 2005

Last year was a great time to be an oil company: Crude briefly shot past \$55 a barrel, the highest ever. It was good to be a bank, too—expansionary monetary policy kept banks' cost of money super-low. For retailers, strong consumer spending made 2004 a year to remember.

In 2005, a lot could change—for better and for worse. Although overall economic growth will be about the same, the ranks of winners and losers are in for a shakeup.

Oil prices may dip a bit, taking some fizz out of the likes of Exxon Mobil Corp. but giving breathing room to energy buyers, from truckers to airlines and petrochemical companies. Banks will have to pay more for deposits as the Federal Reserve continues to tighten short-term interest

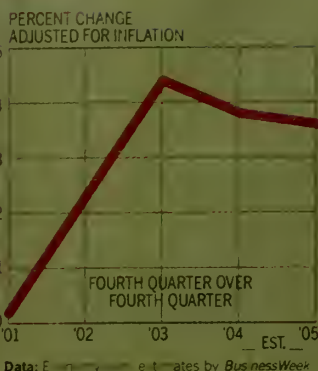
rates. And the indefatigable American consumer could finally start to feel pinched—bad news for retailers and car companies.

Other trends established last year will only strengthen in '05. Thriving suppliers of commodities such as steel and chemicals should fare even better if the dollar drops. On the down side, it's shaping up as another tough year for drug-makers, with many blockbuster drugs under suspicion for possible side effects and others losing patent protection.

Underpinning the sector-by-sector outlook is healthy growth for the economy as a whole. *BusinessWeek's* own forecasters, James C. Cooper and Kathleen Madigan, whose forecasts appear in the charts that follow, expect the economy to grow 3.6% from the end of 2004 to the end of 2005, just a tad below last year's 3.8% pace. The rate of pro-

INDUSTRY OUTLOOK

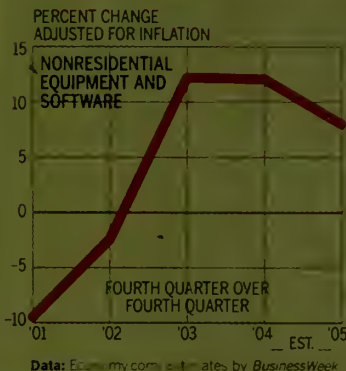
GDP



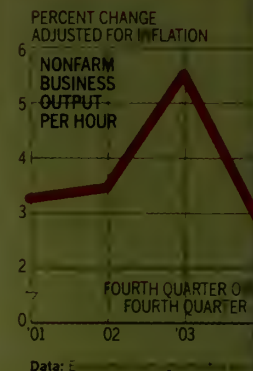
CORPORATE PROFITS



INVESTMENT



PRODUCTIVITY



ductivity growth is likely to dip this year, forcing companies to hire more people to meet demand and causing the unemployment rate to fall modestly. The productivity dip will also keep a lid on the rate of increase in profits, but earnings should nonetheless be higher than in 2004. Says Standard & Poor's Chief Economist David A. Wyss: "We may have turned into a bit of a plodder, but we do keep on plodding in the right direction."

This annual Industry Outlook susses out major sectors of American business, from semiconductors to insurance to basic industry. Each industry's outlook is determined by its own internal rhythms and by changes in the overall economy. The new year will probably be kind to makers of heavy machinery, bolstered by exports to China. Transporters, energy companies, and utilities should have another good year as well. In contrast, consumer goods makers, the financial sector, construction, and most of tech is looking sluggish. In fact, Merrill Lynch & Co.'s equity analysts predict that profits will grow faster in the utility sector than in technology—an inversion of the pattern of past decades.

A lower dollar stands out as one of the "macro" themes of 2005. While currency rates are notoriously hard to predict, one of the better bets is a continued fall in the dollar. Even China, which has long pegged its currency against the dollar, is expected to allow the yuan to move upward a little. Depreciation of the dollar, assuming it happens, will make U.S. exports more competitive while easing the pressure on domestic producers from cheap imported goods. Lehman Brothers Inc. predicts the dollar will fall to 100 Japanese yen from 103 in the next six months, and the euro will rise to \$1.45 from \$1.36 over the same stretch.

The dollar's fall to date—combined with robust world demand—has U.S. manufacturers and their suppliers in a good frame of mind. "We're forecasting

solid industrial pickup," says Michael G. Morris, chairman and CEO of Columbus (Ohio)-based American Electric Power Co., a big utility. "If you talk to the metal melters and the steelmakers, they're already seeing their capacity booked up. The classic part of the U.S. economy, its industrial heart, is cranking again."

On the downside, a falling dollar will contribute to higher inflation and interest rates as foreign investors demand better returns to compensate for exchange-rate losses. Heavy foreign buying of U.S. pub-

lic and private debt securities—in spite of the dollar's steady weakening—kept long-term interest rates remarkably low in 2004, providing a crucial prop for the economy. Rates are likely to rise nearly full percentage point in the new year. That will be hard on the financial sector and on construction, both commercial and residential. An outright free fall in the dollar, while unlikely, could plunge the U.S. into stagflation, which would sick every sector.

The fate of oil will also loom large



Leaders

»»**ENERGY** Added capacity will stabilize oil prices, but China remains a wild card

»»**HARDWARE** Soaring unit sales of consumer gizmos will offset softer prices

»»**AEROSPACE** Another perky year, but leaner times loom for defense companies

»»**MANUFACTURING** Back to basics—heavy machines, steel, and chemicals surge

Laggards

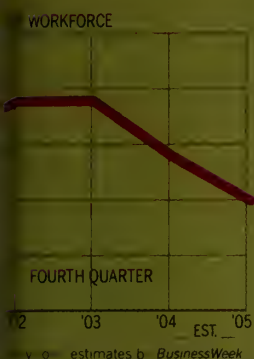
»»**DRUGS** Growing safety worries dog an industry that's short on new products

»»**CHIPS** Revenue growth will stall, but should be less volatile in the future

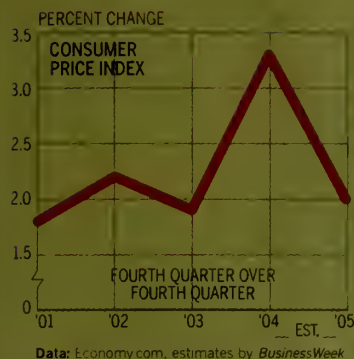
»»**TELECOM** Voice, video, and data move to the Net, shaking up the industry

»»**SOFTWARE** Still stuck in single digits, the market warms to open source

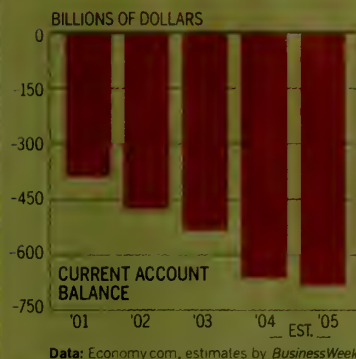
EMPLOYMENT



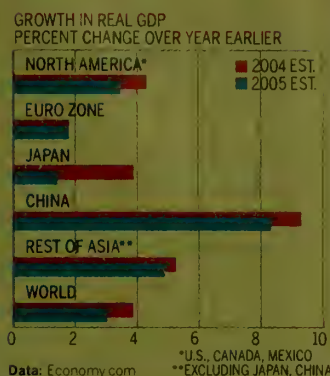
INFLATION



TRADE DEFICIT



GLOBAL OUTLOOK



2005 outlook. Today's high oil prices are eroding consumers' spending power and increasing the costs of businesses, especially airlines, petrochemical makers, and oil-refined airlines. America West Airlines Chairman and CEO W. Douglas Baker says he's planning on oil at \$45 a barrel for next year. "We can't run the business assuming things are going to be better than they are," he says. For American business as a whole, though, the damage from oil seems to be mostly in the past. The smart money is betting on a modest decline in oil prices this year. Just before New Year's, the New York Mercantile Exchange contract for oil was delivered in December, 2005, was a little under \$41, not far from the \$42 price in February, 2005, delivery. Cheaper oil could cause the overall inflation rate to drop this year.

DETROIT BLUES

ANOTHER BROAD THEME for the new year is the tiring of American consumers, who have kept on spending far longer than most economists predicted. Inflation has been eroding the value of family incomes. Rising interest rates would arrest the rapid rise in home prices but has made ordinary Americans feel wealthy and encouraged them to spend freely. The personal savings rate fell to 0.2% of aftertax income in October—down from 5% as recently as 1995. In a partial retrenchment by consumers is likely to hurt retailers and other sectors that depend on free spenders. Detroit, for one, may have a tough 2005. It, too, will benefit a bit from the weaker dollar, but that could be more than offset by the expected weakness in consumer spending, the high cost of materials such as steel, and the big 2004 tax incentives, which caused people to buy vehicles earlier than they'd planned, cannibalizing sales from 2005.

With consumers showing signs of slow-

ing down, the outlook is relatively better for businesses that sell capital goods such as machinery. In the U.S., investment in nonresidential equipment and software is projected to rise 8% in 2005, a healthy number if not quite the 12% growth of each of the past two years. Says Eaton Corp. Chairman and CEO Alexander M. "Sandy" Cutler: "We think the underinvestment in capital stock is really playing into a strong next couple of years."

What's more, makers of capital goods and industrial commodities should see strong gains from exports. Although Europe and Japan are expected to grow less than 2% in the new year, growth elsewhere will pull the worldwide average up to a decent 3%, Economy.com Inc. projects. Caterpillar Inc. Chairman and CEO James W. Owens calls 2004 "a blow-your-socks-off year," and he's convinced that the good news isn't over. For one thing, he expects China—a major buyer of Cat's big yellow machines—to continue growing 7% to 9% a year. Says Owens: "I think we're in the early stages of a long, global, cyclical recovery."

Other sectors will be pushed or pulled by a variety of special factors. Take, for example, efforts to shrink the federal budget deficit. That will hurt aerospace companies like Boeing Co. as well as health-care companies. "Medicare payments to doctors, hospitals, and health plans are really going to be scrutinized

for rollback opportunities," predicts Aetna Inc. Chairman and CEO Jack Rowe. "There will be Medicaid cutbacks, and there will be very little discretionary health-care money available." In contrast, professional services such as ac-

counting should grow strongly, helped by spending on compliance with the Sarbanes-Oxley accountability law.

Information technology will march to its own drummer in 2005. The IT sector has long been one of the fastest-growing and most volatile parts of the economy, but lately it has been a little less of each. Software, telecom, chips, and consumer electronics are among the industries that are expected to grow below their long-term trend rate in 2005. Only the hardware sector is expected to grow briskly. On the bright side, volatility is lessening. Consumers are displacing businesses as the main buyers of info tech. This should stabilize sales patterns, as consumer spending is more regular from year to year.

Each year serves up a new list of winners and losers. On the whole,

though, the signs indicate a good 2005 for American business. ■

—By Peter Coy in New York, with Michael Arndt in Chicago and bureau reports

KEY TO INDUSTRY DATA

On the pages that follow, each story includes a chart and a table. Here's what the numbers mean:

SPOTLIGHTS Show industry performance, by selected metrics, for 2001-05.

2005 PROSPECTS BW has given each industry a grade by comparing its 2005 growth to its growth trend.

2005 GROWTH This forecast of output growth from Economy.com gives the change in the value created by each industry. Unlike a measure of revenue, this "value-added" approach doesn't count the same sales twice.

GROWTH TREND Average annual growth, 1990-2004.

OUTPUT A forecast of the nominal value each industry will create this year.

EMPLOYMENT Estimated number of workers in 2005.

BusinessWeek online For additional executive interviews about the year ahead, go to www.businessweek.com/extras

MANUFACTURING



ENERGY

No Gusher, But A Steady Flow

Oil prices should soften, but China's needs remain a wild card

Producers are adding capacity, which will stabilize price fluctuations

CAN THE ENERGY INDUSTRY top a year when almost everything went in its favor? In 2004, oil and natural gas prices neared or hit record highs, and refiners, running almost flat out to meet demand, posted high profits. But market forecasters anticipate softer oil prices and flat gas prices this year, thanks to slowing economic growth, increased capacity, and more conservation efforts by manufacturers and consumers. As in so many other sectors last year, China emerged as a powerful force in global energy markets. Surprisingly strong Chinese demand helped boost worldwide demand by 2.5 million barrels per day (bpd)—or 3.1%—to 6 million bpd, says James Burkhard, director of global oil market research at Cambridge Energy Research Associates Inc. That was the biggest volume since 1978 and more than the average annual growth over the past six years. Any fall in world energy prices in 2005 will therefore depend in part on Beijing's effort to cool down the economy. The International Energy Agency predicts that global demand this year will grow by a slower 1%, or by 1.4 million bpd. Years of supply disruptions should ease

later this year. With both OPEC and non-OPEC producers adding capacity, Burkhard predicts that the cushion of spare capacity could grow to a comfortable 3 million bpd by the end of 2005, closer to its level over the past decade. In late 2004 there was just 1 million to 1.2 million bpd of excess capacity, leaving little margin for error, and contributing to the geopolitical jitters that kept oil futures jumpy all year.

In fact, with prices already \$10 a barrel from their peak and supplies plentiful, OPEC is now moving toward cutting production. It wants to avoid a glut that might cause the price of oil to crash, as it did in 1998, when it briefly touched \$10 a barrel. Benchmark West Texas Intermediate (WTI) crude will average \$37.67 a barrel in 2005, vs. \$40.89 last year, according to Thomson First Call consensus estimates. Of course, that assumes there's no sudden

volatile—is greater for natural gas. North American production can't match demand growth. The U.S. Energy Information Administration predicts natural gas demand will grow by 3.7% in 2005, especially due to rising demand for gas-fired electricity generation. Yet domestic gas output will grow by only 1.9%. That gap makes for rising prices. Craig Pennington, global energy group director at Schrodgers, expects U.S. natural gas prices to climb to an average of \$6.45 per thousand cubic feet in 2005, from \$6 last year.

WIN SOME, LOSE SOME

IT WOULD HELP if the U.S. could import more liquefied natural gas from overseas. Yet boosting the flow of imported LNG, which now accounts for 4% of U.S. supply, is hard because there are too few of the specialized port terminals needed to offload LNG. Dozens have been proposed, but many face community opposition. Given the long lead times to permit and build the plants, LNG imports won't have a major impact until at least 2008.

The demand for electric power is also outpacing the growth of supply. Energy researcher Platts, which like *BusinessWeek* is a unit of The McGraw-Hill Cos., predicts that U.S. power demand will grow at a 2.3% pace through 2008. But total U.S. generating capacity will expand by just 1.6%, or 15 gigawatts, in the new year. Total earnings for the 27 largest electric utilities will rise by 15% in 2005, to \$20.9 billion, predicts Reuters Estimates. Meanwhile, the grid has seen only limited



collapse in demand caused, for example, by a recession. "OPEC can manage supply. It can't manage demand," says Burkhard. A shortage of critical infrastructure, from refineries to pipelines, should also help to keep crude prices from collapsing.

The risk that prices will rise—and be

physical upgrades since the August 2003 Northeast blackout. The officials that manage power flow over the grid have altered their rules to prevent a repeat of the events that triggered the failure.

In the oil patch, last year's earnings gusher is clearly over. Thirteen major oil companies in 2004 posted a "spectacular" 46% surge in profits, to \$96 billion, figures analyst Frederick P. Leuffer of Bear, Stearns & Co. Based on his below-consensus average forecast of \$25 per barrel for WTI and some easing of refining margins, he projects a 40% earnings drop for the year. Looking at a broader group, Thomson First Call predicts that profits for the 27 energy companies in the Standard & Poor's 500-stock index will fall 5% this year, after a 47% climb in 2004.

Cautious oil and gas companies are planning modest increases in exploration and production (E&P) expenditures. Some of that increase will simply cover higher costs, as steel, oil field services, and other

expenses continue to rise. According to a recent Lehman Brothers Inc. survey of 327 oil and gas companies, worldwide E&P expenditures will rise 5.7%, to \$176.8 billion, in 2005. That compares with a 12.4% boost in 2004.

For now, at least, the main expansions planned in the U.S. are by smaller independents. Tiny Fort Worth-based Cano Petroleum Inc., which is squeezing more oil out of mature U.S. fields, is planning to boost its acquisition and development budget by at least 300% to over \$20 million, says CEO Jeff Johnson. But supermajors like Exxon Mobil Corp. will go on returning cash to shareholders through stock buybacks and dividends. That's partly because they lack access to the best new drilling sites worldwide, such as Russia and the Mideast, says Matthew R. Simmons, CEO of energy-focused investment bank Simmons & Co. International.

Some U.S. producers are hoping Congress will pass the proposed energy bill

that has been stalled on Capitol Hill for three years. Their wish list includes opening up more drilling prospects at home, including in federal lands in Alaska and the Rockies. Environmentalists are sure to resist, and even supporters acknowledge the plan would do little to improve the domestic supply picture. The greens may find little place if the White House balances a renewed push for more oil and gas subsidies with fresh incentives for renewable energy. No matter what, the chances for a single omnibus energy bill are slim. But even without Washington's help, the energy industry is counting on another bright year. ■

—By Wendy Zellner in Dallas
Christopher Palmeri in Los Angeles
John Carey in Washington

ALTERNATIVE ENERGY

Tax Credits Put Wind in The Sails of Renewables

Fickle breezes pose a challenge for Steven Zwolinski, president of GE Wind Energy. But in 2004, he was also hit by the capricious winds of politics. A tax credit for wind energy, expected to be renewed, expired in 2003 after being caught up in the congressional stalemate over a comprehensive energy bill. As a result, new wind farm development came almost to a halt. By summer, Zwolinski had no orders and nearly \$300 million in inventory, forcing layoffs and factory closings. The uncertainty over policy makes for a "tough industry," he says.

But what governments take away, they can also give. In September, Congress renewed the wind tax credit and extended credits to most other types of renewable energy. In addition, 19 states now require that electricity providers offer a certain percentage of green energy. And around the world, noncarbon-emitting alternative energies are needed to meet the terms of the Kyoto Protocol, which requires cuts in greenhouse-gas emissions.

Factor in falling clean energy costs and rising prices for coal, oil, and gas, and these issues are turbocharging green power. Indeed, renewable energy forecaster Clean Edge expects the overall market to grow from \$13 billion worldwide last year to \$92 billion by 2013. "These technologies are at a tipping point," says Clean Edge's Ron Pernick.

The biggest winner: wind. "Clearly, wind is set to come on stronger than last year," says Fred Mayes, chief of the Energy Dept.'s renewables information team. With the tax credit, wind power has plunged from 45¢ per kilowatt-hour in 1980 to less than 3¢ today, making it competitive with natural gas- or coal-fired plants. Power providers are rushing to take advantage of the credit before it is scheduled to disappear again in 2006. "We're now seeing a 14-month sprint until the end of 2005," says Jack Ihle, energy analyst at Platts

(a unit of The McGraw-Hill Cos., as is *BusinessWeek*). Platts projects that the U.S. will add more than 2,400 megawatts of wind capacity in 2005, on top of the existing 6,300 MW.

Falling clean-energy costs and rising oil prices are turbocharging green, too



Similar incentives are fueling solar power, which remains more costly than fossil fuels and is even more dependent on government incentives, says ABI Research analyst Jose Laurito. Germany, for instance, has made a major bet on the technology, creating "such incredible demand," he says, that it's driving up prices for solar systems around the world. Companies like General Electric, BP, Royal Dutch/Shell, Sharp, and Kyocera see sun power as a big chunk of their future business, and new approaches such as plastic-based solar panels are springing up. Forecasters see more than 30% growth per year for the next decade.

The renewable industry is largely the creation of government policies, and there's always a chance that the political winds could shift. But given environmental pressures and more competitive green energy prices, it's a good bet that the boom in renewables will continue.

—By John Carey in Washington



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BASIC INDUSTRY

More Good Vibes For Heavy Metal

»Commodities suppliers are profiting from rising prices and strong global demand

»Heavy-equipment makers, though braked by the cost of metal, are cashing in as well

ALL THOSE ATKINS adherents aren't the only ones on heavy diets. Around the globe, en masse, manufacturers are bingeing on iron, copper, and aluminum and sending the prices of these commodities soaring. It has been a terrific turn for steelmakers in particular, lifting them from a five-year slump. Now the question is whether this is only a passing fancy—as low-carb foods may prove to be—or whether the world's metal-benders will be hungry for more in 2005.

It looks as if plenty will be back for seconds. The Big Three auto makers may be getting full, but heavy equipment makers such as Caterpillar Inc. and Deere & Co. plan to step up production in 2005. Ditto for truck manufacturers like Navistar International Corp. Despite government slowdown efforts, China's commodity-gobbling economy is on track for another banner year, with low-cost economies elsewhere in Asia and in Latin America not far behind. Moreover, the civilian-aircraft industry and nonresidential construction in the U.S. show



hints of snapping out of multiyear downturns, broadening the rise in capital spending and consumption of basic materials. "What you're seeing," says Alexander M. Cutler, chairman and chief executive of industrial goods outfit Eaton Corp., "is a demand-driven escalation in metals prices."

And it's not just metals that are hot. With its orders climbing and plants running near capacity,

Dow Chemical Co. raised prices throughout 2004, more than making up for an estimated \$4.3 billion rise in its own energy and feedstock bill. One example is plastics: Polyethylene has gone up 34% in the past year, according to price trackers at *Pur-*

chasing magazine. And Dow has nounced further hikes for 2005. "When we talk to customers, price isn't their main concern; it's getting enough product," says CEO Andrew N. Liveris. "It's across the board and across all geographies." The American Chemistry Council predicts industry revenues will surge 5% to \$535.5 billion, in the new year.

Higher prices weren't surprising in 2004, given the tight market. But inventories have been restocked, which will soften demand somewhat in 2005. General Motors Corp. and Ford Motor Co., for instance, are slowing production to work off inventories at overstocked dealer lots. China, whose red-hot economy has been scarfing up basic materials faster than it can make them, has throttled its construction industry.

CRAVINGS

ON THE SUPPLY side, steel companies and others have added capacity in the U.S. through targeted upgrades of factories. Capacity in China is also growing at an unheard-of clip. The result: Prices of many industrial metals, which hit 20-year highs in some cases last autumn, have slipped. Commodity-grade sheet steel, which is used in everything

from big-box buildings to vehicle undercarriages, is off 13% from a recent high of \$750 a ton to \$650 a ton on the market at yearend.

By and large, though, economists and industry executives say demand is likely to outpace capacity growth in 2005. As business investment grows, Danie Meckstroth, chief economist at Manufacturers Alliance/MAPI, predicts capital spending on equipment will increase 9.3%, adjusted for inflation, more than twice as fast as the overall economy. Moreover, the weakened dollar should shift more orders to domestic producers. Taken together, they should support growth this year in 20 of the 24 industries that Manufacturers Alliance/MAPI monitors. Industrial machinery will expand by 8%, on top of 2004's 11% rise, Meckstroth adds, while metalworking machinery output should jump by 11% in 2005, n

SPOTLIGHT



2005 PROSPECTS

A-	Output Growth 3.6%
Growth Trend*	2.2%
Output	\$979 bil.
Employment	9,420,000

*Avg. yearly change, 1990-2004
Data: Economy.com (page 91) Grade: BusinessWeek

an double its 5% growth in 2004. Few are enjoying the world's craving for commodities more than steelmakers. Nucor Corp. began the year with 70% of flat-rolled steel output for all of 2005 already sold. And it has been able to levy surcharges on customers to cover high raw material costs. A year earlier, by comparison, it had locked up just 25% flat-rolled capacity.

U.S. Steel Corp. is also profiting from strong demand. The company earned an estimated \$845 million last year, after losing \$540 million from 1999 through 2003 when a worldwide glut of supplies swamped prices. CEO John Surma Jr. concedes that '05 will be to a slower start, in part because of a drop in vehicle production. Still, even after slipping recently, steel prices have doubled in a year. And with industry output expected to rise 6%, he says 2005 could turn out to be as profitable as 2004. "Anybody who's making steel is making all they can," he notes. "The fundamentals are looking pretty good."

The high price of industrial metals frightens customers, even as it helps suppliers. Eaton's Cutler calculates that his company paid \$140 million more for steel and other metals in 2004 than in the prior year, cutting earnings by \$70 million. Caterpillar Chairman and CEO James W. Owens complains that profits are crimped not only by higher steel prices but also by shortages, as component suppliers struggled to keep up with demand. With Caterpillar's production scheduled to increase as much as 10% in 2005, Owens is not expecting much relief on raw material costs. Meanwhile, Maytag Corp. foresees steel prices slicing a further \$60 million, or 15%, from its net income in 2005, says George C. Moore.

These industrial consumers aren't helpless, though. Taking advantage of strong demand for its machinery and turbines, Caterpillar hiked its prices in 2004, by 5.5% all together. It scheduled another across-the-board increase of 3% for Jan. 1. To recover at least some of its higher raw material expenses, Maytag also raised prices of its big-ticket appliances by 5% on New Year's Day. Eventually, manufacturers will lose their appetite for steel, and storerooms will be filled with unwanted coils of steel and ingots of aluminum. But the heavy metal diet is as if it'll be popular at least another year. ■

—By Michael Arndt in Chicago

AEROSPACE

Preparing For a Descent

» The industry expects a gradual downturn in defense procurement...

» ... cushioned (if fuel prices don't skyrocket) by a climb in commercial airline orders

AEROSPACE EXECUTIVES undoubtedly wished that 2004 would go on forever. Total industry sales stretched 8% over the previous year, to a record \$161 billion. Even better, profits soared to \$10 billion—the best in five years. And for the first time in two years, commercial jet deliveries inched higher.

Most industry analysts see a modest spurt in orders for commercial jets this year as well. Still, a number of conflicts or financial crises could disrupt aerospace fortunes. Rising fuel prices and record government deficits are the most pressing concerns. Less likely, but still a threat, is a full-blown recession or another terrorist strike on U.S. shores.

Prospects for the military market are mixed. In the long term, analysts expect sales to soften. "The defense marketplace will become even more competitive as budgets are reduced and nontraditional competitors enter this business," says James F. Al-

baugh, Boeing Co. chief executive for Integrated Defense Systems. And some Pentagon programs, he admits, "could be on the list to cut."

Beginning this year, arms merchants will start to feel the effects of smaller increases in defense dollars. How much less money is anybody's guess, but part of the Pentagon's budget of nearly \$500 billion will shift from research and development and procurement to military pay, health care, and other basic needs. Big-ticket items, such as the F-22 Raptor jet fighter, aren't in danger of getting axed, but annual support will dwindle. "It's hard to conceive that defense

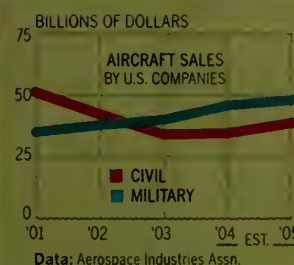


spending will continue to rise after five years of dramatic increases, at the same time that Social Security spending and domestic spending are being cut," says

Steven M. Kosiak, budget-studies director at the Center for Strategic & Budgetary Assessments, a Washington think tank.

The message to defense contractors is clear: Start tightening your belts. But neither the Bush Administration nor

SPOTLIGHT



2005 PROSPECTS

A	Output Growth	1.7%
Growth Trend*	-2.1%	
Output	\$30.0 bil.	
Employment	438,000	

*Avg. yearly change, 1990-2004
Data: Economy.com (page 91) Grade: BusinessWeek

Congress is going to smack them this year with shock-and-awe cutbacks. In fact, the Aerospace Industries Assn. predicts another round of growth in 2005, with total sales up by 7.5%, just a smidgen below last year's 8%, to \$173 billion. Military aircraft and missile sales, which rose 10% in 2004, will again drive the growth. So big names such as Lockheed Martin, Raytheon, and Northrop Grumman will collect most of the gains. Still, "it will be a transitional year, psychologically," says Lehman Brothers aerospace analyst Joseph Campbell. "Defense companies and the Pentagon will realize that the better growth days are behind them."

FUEL-SIPPING JETS

IN CONTRAST, THE CIVIL outlook is brightening further. Analysts estimated that Airbus and Boeing would deliver 324 and 287 jetliners, respectively, in 2004, and higher numbers are forecast for this year: 340 jets for Airbus, vs. 324 for Boeing. Both are upbeat about new midsize planes that may appeal to low-cost carriers. In December, Airbus announced the A350, an upgrade of its popular A330 midrange jetliner, to compete with Boeing's new fuel-sipping 7E7 Dreamliner. Airbus CEO Noel Forgeard says he hopes for 50 orders of the A350 by June. Boeing Commercial Airplanes Chief Executive Alan Mulally confidently asserts the 7E7 will reach 200 orders faster than any jet ever has.

Any pickup in big-jet sales depends on how fast traditional U.S. airlines recover. Only one of the top 10 U.S. carriers, Southwest Airlines, made a profit last year. But with worldwide passenger traffic up 10% last year and expected to rise 7% in 2005, analysts say, U.S. airlines could be on the mend by 2006.

Even then, new plane orders could lag by another year or two. That's why Merrill Lynch & Co. analyst Byron Callan urges caution. The airline industry is changing for many reasons, including gains by low-cost carriers, the popularity of 70- to 110-seat regional jets, and higher fuel prices. As a result, Callan suggests, deliveries to legacy airlines may just "muddle through" to 2008 or 2010. At that point, a takeoff in demand will hinge on the airlines sorting out their cost problems.

The bottom line for aerospace folks: Strap on your seatbelts, we'll be experiencing a little turbulence. ■

—By Stanley Holmes in Seattle, with Stan Crock in Washington



CONSTRUCTION

Still Building

» With interest rates rising, residential construction will be off its torrid pace of 2004

» Commercial developers will pick up the slack with new office and retail projects

FOR THE FIRST TIME in four years, the banging of hammers will be a bit quieter in 2005, as the pace of homebuilding cools. Squeezed by rising interest rates, 1.55 million single-family houses will be erected in 2005, down 3.6% from last year's all-time high, but still the second-best count ever. The big brake: The 30-year fixed-rate mortgage is likely to hit 6.75% by yearend, up from an average of 5.9% last year. The pace also will slow partly because last year's sales were so ex-

uberant, says David F. Seitz, chief economist at the National Association of Home Builders.

On the commercial side, growth will surge past a robust 2004. Construction for offices, stores and multifamily dwellings will rise to \$120 billion, according to McGraw-Hill Construction. That's up from the \$112 billion spent at the peak of the dot-com bubble in 2000. Retailers will continue to add outlets: Home-improvement giant Lowe's Cos. will open 150 outlets in 2005. And continuing its aggressive expansion, Wal-Mart Stores Inc. will build or expand up to 250 supercenters. "There's a sense that the economy is improving, and new construction will help these players catch the uptick," says Robert A. Murray, McGraw-Hill Construction's top economist.

Office building is also on the rebound. The national vacancy rate remains high at 17.4% at the close of 2004, down from 18.2% a year earlier. So while developers are planning new construction, they are being more selective. Many are still shy after being saddled with acres of empty space following the dot-com crash. Such projects are increasingly prefinanced, with as much as 70% preleased in new buildings, up from 20% historically, according to Maria T. Sicola, a senior managing partner at real estate services firm Colman & Wakefield Inc. Overall, 170 million square feet of offices will be available next year, up 10% from 2004. Stronger public finances will help boost public construction by 3% in the year as well, according to the Manufacturers Alliance/MAPI. This follows a slow 2004, when weak public financing across the country stifled building schools, roads, and public edifices.

With few weak spots expected in 2005, overall construction spending will rise 2%, to \$585.5 billion, according to McGraw-Hill Construction. And homebuilders remain bullish. Arlington, Va.-based D.R. Horton Inc. expects to

over 50,000 homes this year, up from 48,000 in 2004. In mind interest rate recessions, or says CEO Donald Tomnitz, "we're going to make our in 2005." Q hammers, for n but not silent. ■

—By Brian in At

SPOTLIGHT



Data: McGraw-Hill Construction

2005 PROSPECTS

C	Output Growth	1.1%
	Growth Trend*	3.1%
	Output	\$1,605 bil.
	Employment	9,374,000

*Avg. change, 1990-2004

Data: Economic Commission of the Organization for Economic Cooperation and Development

Putting the Pedal To the Metal

Demand for shipping by air and truck is strong, and prices are rising

Companies are struggling with a shortage of railcars and truck drivers

FOR THE NATION'S beleaguered transportation sector, it's now full speed ahead. Demand for shipping by air and truck has never been greater: In the trucking sector alone, volume is expected to rise, while rail shipments are expected to climb up 3.8%, and air freight follows at more than 1%. Given this favorable backdrop, Paul Bingham, transportation analyst for Global Insight Inc. in Washington, expects gross operating profit for the transportation industry to climb 5.5% in 2005, to \$208.5 billion, on top of the frothy 24% rebound in profits booked up in 2004. That has transportation executives feeling optimistic about 2005. "We think we're in a real sweet spot," says D. Scott Davis, chief financial officer for United Parcel Service Inc.

For customers, though, it's another story. The trucking and rail companies that serve them are strapped for capacity, but instead of making necessary investments, they're content to bank their fattening profits. That's because execs in these industries can't forget the searing overcapacity and poor returns of recent years. Matthew K. Rose, CEO of Burlington Northern Santa Fe Corp., says that of the

\$1.9 billion Burlington earmarked for new capital spending last year, no more than \$300 million went toward adding capacity.

The lack of spare rail cars is likely to worsen bottlenecks at major West Coast ports, where shippers complain there aren't enough rail cars to offload incoming shipments from Asia. But for now, rail execs are unrepentant. "I'm not going to put us in a place of having too much new capacity as long as our industry is underperforming," says Rose, who notes that many rail carriers still don't earn enough to finance further borrowing.

Trucking executives say they also have

been unable to put new trucks on the road—but not for lack of trying. Their problem is a chronic shortage of drivers. Many candidates get siphoned off by better-paying jobs in the homebuilding business. That has prompted trucking outfits, already pinched by higher insurance premiums, to push up salaries by as much as 10%. Schneider National Inc. in Green Bay, Wis., recently gave its 15,000 drivers average raises of \$4,000, to as much as \$45,000, and executives admit that driver salaries may have to top \$60,000 in the next few years to attract the needed talent. "It's the worst imbalance I've seen in my 25 years," says Scott Arves, Schneider's president of transportation. He adds that his company is now turning away roughly 5% of customer orders because of the lack of drivers.

The net effect of this shipping imbalance

SPOTLIGHT



2005 PROSPECTS

B

Output Growth
3.9%

Growth Trend*	3.2%
Output	\$143 bil.
Employment	2,245,000

*Avg. yearly change, 1990-2004
Data: Economy.com (page 91) Grade: BusinessWeek

ance is that many transportation companies are sharply jacking up prices. Arves, for one, predicts average truckload rates will rise as much as 6% to 8% in 2005. And whereas past price hikes often failed, industry executives say the latest rate boosts are sticking. Last year was "probably the best in the past 10 to 15 years in our ability to retain price increases," says William D. Zollars, chief executive of Yellow Roadway Corp.

Shippers acknowledge that the current supply shortage is likely to worsen before it gets better. "In the past two years, the balance of power has shifted," admits Susan Alt, president of Volvo Logistics North America Inc. While some shippers say they're forming their own trucking lines, Alt has taken a more creative tack: She has found modest success at getting private fleets—say, trucks delivering shipments for the major grocery chains—to carry her shipments on their trips home, when they'd otherwise return empty. Given the current capacity crunch, shippers will do whatever it takes to get their goods on the road. ■

—By Dean Foust,
with Michael Eidam, in Atlanta



AUTOS / COMMENTARY

Borrowing from the Future

After years of lavish sales incentives, demand for cars is flat. With higher interest rates ahead, Detroit's best bet is to offer better cars **>> BY KATHLEEN KERWIN**

IF ONLY GENERAL MOTORS AND Ford were in the finance business. Their lending arms rake in billions. But profits on autos at GM, Ford Motor, and DaimlerChrysler's Chrysler Group have been hammered by the raging incentives war. And in spite of \$5,000-plus rebates on some models, the Big Three's share of the U.S. market fell to a record low of 60.1% by late last year.

True, it was incentives like those—and more modest deals from Japanese and European carmakers—that kept car sales fairly robust through recession and war during the past three years. But now the tab is coming due. The deals that persuaded consumers to trade in their old models early stole demand from the future, sapping the rebound that typically follows an economic upturn. That's why most industry watchers expect U.S. car and light-truck sales in 2005 to total 16.6 million vehicles, roughly level with 2004's 16.7 million tally. "It appears that the pull-ahead we've worried about is happening," says Chrysler CEO Dieter Zetsche. "There is no pent-up demand."

The economy isn't likely to give carmakers a break, either. "This has been the best year of the cycle," says Comerica Bank Chief Economist David Littman. "Without a tax cut, we won't repeat it." Real disposable income has been growing at better than 4%, he says, but it's all downhill from here. And when disposable income growth falls to 2.6% or less, he adds, auto sales nearly always decline.

Steeper interest rates could further deflate auto sales, as the cost of financing a new car rises. And, contends Chrysler Corporate Economist Van E. Jolissaint, "the biggest risk continues to be oil prices." Persistent high fuel prices would take a bite out of sales—and not just for gas-guzzling sport-utility vehicles. Buyers whose budgets are dinged by high gasoline and heat-

ing-fuel prices could delay their car purchases, Jolissaint says. Meanwhile, rising energy and commodity prices will cut into auto makers' profits. Higher steel prices have added as much as \$500 to the cost of a vehicle, says Robert Schnorbus, chief economist at J.D. Power & Associates. But competition is so intense that most carmakers are eating the extra cost. "They fight to get and nail for pennies in savings, so this is a tremendous battle," Schnorbus says. Detroit's 2005 dilemma will be how to turn the rebate spigot. Every effort to wean consumers so far has

sulted in an immediate plunge in Big Three sales. Cutting discounts would help, but domestic carmakers fear losing more share.

The only true escape from incentives is to sell better cars. At Chrysler, a new generation of minivans, plus the Dodge Magnum sport wagon and Chrysler 300 sedan, pushed sales up 3.2% in the first months of 2004, with few or no incentives.

Ford is hoping its newly launched passenger cars will post



the kind of sales kick in 2005 that it got from revamped Ford pickups in 2004. But it's too early to tell if the new cars will hit. The all-new Mustang already looks like a winner. But analysts doubt that any of Ford's trio of new family cars—the Ford Five Hundred and Mercury Montego sedans and the Freestyle sport wagon—will match the sizzle of Chrysler's

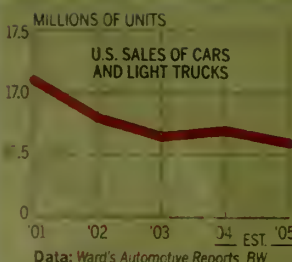
GM is in the toughest position of all. The result of the maker's launch of five new models in 2004 was a half-point decline in market share, to 27.6%, through November. The product pipeline for the year ahead doesn't promise much. Says B. Craig Hutson, senior bond analyst at Gimme Credit, an independent bond research firm: "For GM, 2005 will be more of a hang-in-there year." Indeed, Detroit pundits are wondering whether GM's last-gasp December sales push is a "real sale," as advertised, or a white flag of surrender.

Industry execs hope the incentives peak has passed. Yet demand weakens, they may have little choice but to continue to dole out loans and discounts. Says Diane C. Swonk, an independent Chicago economist: "Unless carmakers want to take cars away, sales will fall." In that case, they'll be leaning on their finance units harder than ever. ■

—With David Welch in Detroit

SPOTLIGHT

2005 PROSPECTS



C+ Output Growth 4.4%

Growth Trend*	4.6%
Output	\$373 bil.
Employment	4,300,000

*Avg. yearly change, 1990-2004
Data: Economy.com (page 91) Grade: BusinessWeek



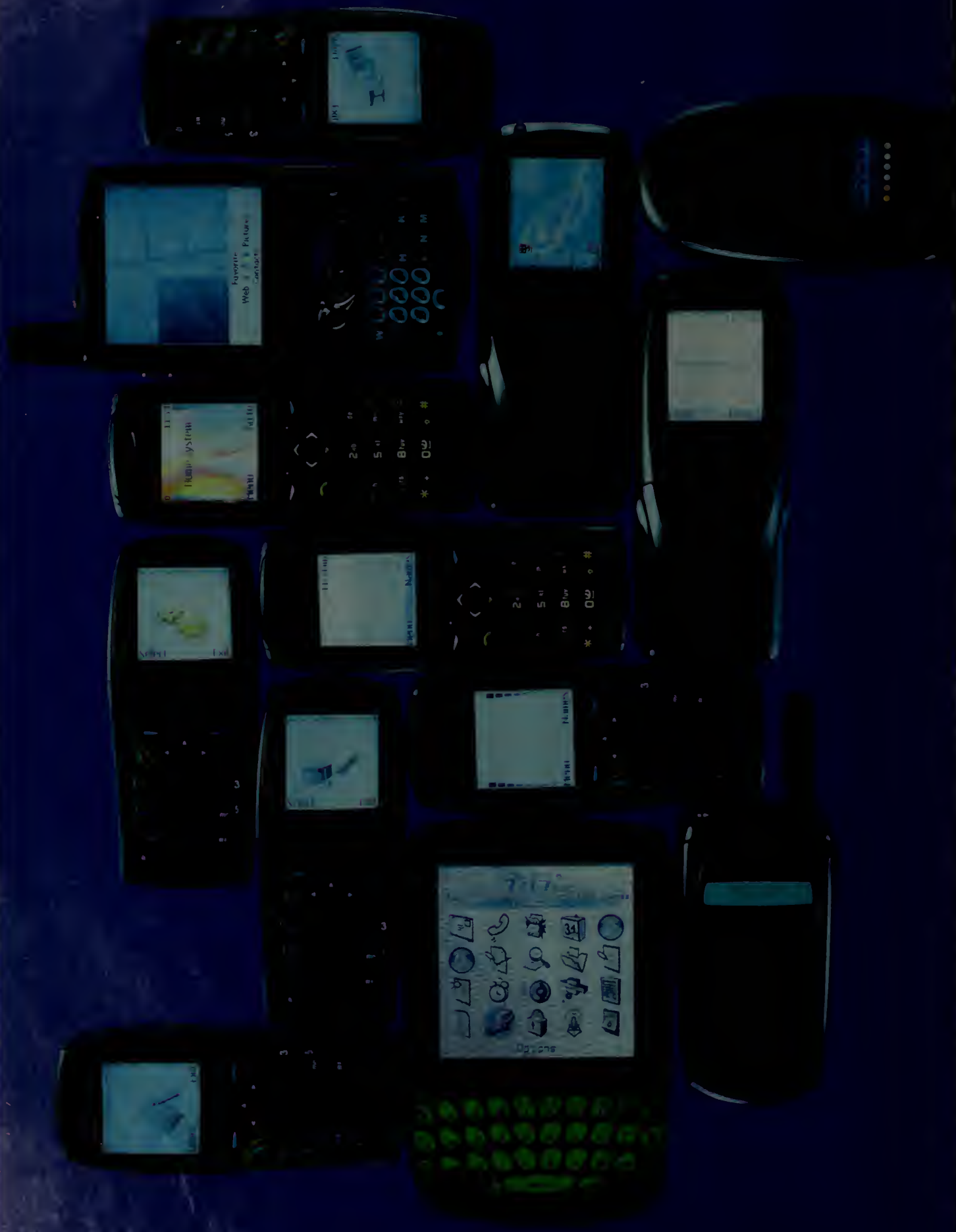
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INFORMATION TECHNOLOGY



TELECOM

The Merger Is the Message

Net technology is replacing old methods, ushering in an era of souped-up services

Distinctions within the industry are blurring as outsiders make inroads

LAST YEAR ENDED WITH a bang in telecom. During the final three months, Cingular closed its \$41 billion acquisition of AT&T Wireless, and Sprint announced a \$35 billion mega-merger with Nextel Communications. At a time when interest in additional telecom companies is as rare as rotary phones, mergers are a sign of profound changes afoot. "These kinds of deals create enormous opportunities to rethink the whole telecom sector," says Francis McInerney, managing director of consultant North River Ventures LLC.

By bulking up and bearing down, companies are sparking innovations that will transform communication. Wireless voice is just the start. More and more, mobile phones will be used to exchange e-mail, music, and even video. Likewise, Internet technology will replace old-fashioned phone gear, ushering in an era of souped-up services. Consumers will get voice mail on their PCs and all-you-can-eat phone service for under \$25 a month, while businesses hand out mobile phones to field warriors so they can receive calls and e-mail just as if they were in the office. Says Randall L. Stephenson, COO at

SBC Communications Inc.: "2005 is going to be a very transformational year. You'll see the lines between services really begin to blur."

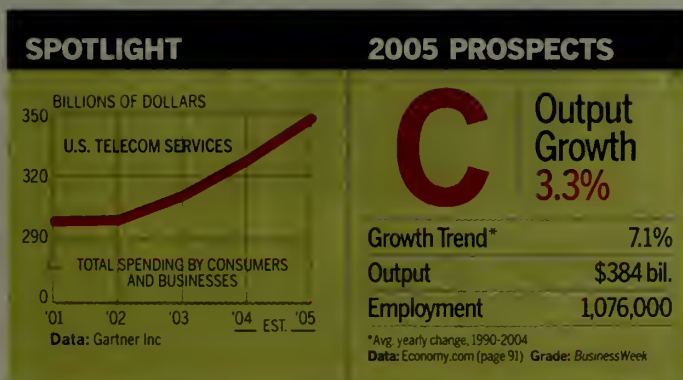
The distinctions among industries will get fuzzy, too. In 2005, telecom giants Verizon Communications Inc. and SBC will pursue licenses to market cable TV. AT&T plans to market security software to corporate customers. Comcast and other cable players are barreling into residential phone markets, and even sports power ESPN expects to unveil hip mobile phone offerings. "Telecom service as we know it is about to explode," says Richard Siber, a wireless expert and founder of SiberConsulting LLC.

The dust-up should serve as an industry catalyst, as new services at lower prices spill into the marketplace. Revenues from all U.S. communications

to rise 11%, to \$122.5 billion, while revenues from broadband and other data services are projected to rise 12%, to \$93.9 billion.

Competition in those markets will grow even keener. Comcast Corp. is leading a consortium of cable operators that is exploring ways to break into wireless services. There's a strategic reason for the move: The cable companies are offering home phone service with Internet protocol technology, but without a mobile offering, they lack an essential element of the telecom bundle. The cable companies are trying to work out a partnership with Sprint Nextel or possibly T-Mobile USA to sell consumers a dual-mode phone that would handle their IP calling service inside the house and switch to cellular systems outside. AT&T will unveil a similar service this year.

The scrum may spark more consolidation. Cable companies could consider acquiring a wireless company if the partnership approach fails. Separately, Verizon Wireless may look to gobble up a midsize player, such as Alltel or U.S. Cellular Corp., now that Cingular Wireless LLC and Sprint have bulked up. And while SBC and BellSouth Corp. are focused on helping combine AT&T Wireless with Cingular, which SBC and BellSouth co-own, SBC might not be finished. CEO Edward E. Whitacre Jr. has made no secret of his desire to own Cingular outright. "Of course I wish I owned it all," he told *BusinessWeek* in October. That could happen by his buying BellSouth's stake in Cingular or buying BellSouth itself. Bell-



services are expected to climb 6%, to \$347.5 billion, in 2005, according to researcher Gartner Inc. That's despite a decline in traditional voice service to \$131.1 billion, down from \$133.5 in 2004. Emerging services will drive spending. Wireless revenues are forecast

South says it's not interested in being acquired and doubts that regulators would approve such a deal anyway.

Behind the intense positioning is a simple proposition: Mobile devices may evolve into the primary tool for managing work and play. The number of U.S. wireless subscribers will surpass 180 million next year. And IDC says customers will dole out \$83 million—a 28% jump over last year—to send photos and video clips, surf the Net, and zap e-mails.

Services are growing ever more advanced. AT&T is testing a service it hopes to unveil by yearend that will allow corporate users to whip out handheld computers, connect to a corporate database, manipulate spreadsheets back in the office, field e-mail, or hold a videoconference—all while 30 miles away from a radio tower and without a risk to security. "That's very powerful," says AT&T's chief strategist, Eric Shepcaro. "It's a real enhancement to productivity."

The battle among providers means lower prices, too. Consider the impact of tiny Vonage Holdings Corp. By deploying voice over Internet protocol (VoIP) to offer inexpensive phone service, Vonage, unknown a year ago, is now the fastest-growing U.S. phone company. It's adding 30,000 customers per month, with a total of about 300,000 at the end of 2004.

TURF WARS

BUT VONAGE HAS competition from some unlikely quarters. AT&T has embarked on a price war with the upstart, resulting in each lowering prices a couple of times in 2004 before bottoming out at less than \$25 a month. Cable operator Cablevision Systems Corp. says it's adding close to 30,000 phone customers per month. Time Warner Cable, meanwhile, says it's signing up about 40,000 phone subscribers per month. In all, 1 million

folks are using VoIP technology in U.S. That's a fraction of the 113 million line residential market, but Yankee Group forecasts such services will reach 17.5 million residential users by 2007.

To counter this encroachment of their voice territory, the telcos will unleash spiffy new video services. Sprint, for example, plans to spend \$800 million in 2005 to make video service available to more than 2 million homes. Verizon also will spend lavishly to unveil TV programming. Meanwhile, SBC's Net-based technology will allow users choose the camera angles in a football game, read and hear e-mail on a big screen, and completely customize their onscreen TV menu. "This is sci-fi stuff," says SBC's Stephenson. "As long as the service companies lead the innovations coming, there's no danger that customers or investors will wander away."

—By Roger O. Crockett in Chicago

NETWORKING

A Welcome Nudge From the Net

Ever since the telecom boom came to a screeching halt in 2000, it seemed the downturn that hammered communications-gear makers would never end. But now, as phone companies roll out a slew of new whiz-bang services, relief is finally arriving. The overall telecom gear market is expected to rise 11% in 2005, to \$84.6 billion, and keep going to \$102.4 billion by 2007, according to Synergy Research Group Inc.

Remarkably, this growth will happen with no help from the traditional telephone market. Demand for the gear that phone companies have used for decades to handle basic phone calls is in a free fall, plunging from \$55 billion in 2000 to \$15 billion in 2004—and it's expected keep on shrinking.

So what's driving the growth? Credit the Internet. Desperate to move into new markets to parry attacks from cable and cellular rivals, phone companies are adopting gear similar to what runs the Net. Since it can handle any kind of digital traffic—be it a phone call, e-mail, or a Desperate



Housewives episode—this gear is the most cost-effective way for phone companies to build new businesses and protect old ones.

Equipment makers are cashing in on demand for Internet gear

In the 1990s, says Scott G. Kriens, CEO of router-maker Juniper Networks Inc., "Everyone expected this [move to Internet-style technology] to happen overnight. When it didn't, they figured it never would. Now it has."

That's largely because the

latest gear can now match, or even surpass, the reliability and features of traditional approaches. Take voice-over-Internet-protocol (VoIP), which has long promised a way to offer basic phone service at a fraction of the cost of old technology. While VoIP services in the past suffered from scratchy sound and frequent disconnections, the quality and features today can exceed those of traditional phone service. Carriers such as AT&T are using it to offer unlimited calling for as little as \$20 a month. Merrill Lynch & Co. expects the market for VoIP gear to hit \$4 billion by 2008, from \$800 million in 2004.

Another sweet spot will be for gear that carries video and other byte-hogging media over traditional copper phone lines. Ringgold Telephone Co. in Ringgold, Ga., for example, has purchased two cabinets of gear from startup Calix Inc. to offer TV-on-demand services to head off competition from its local cable-TV rival. "We're not seeing any growth in our wireline business, so we had to find other things to do," says Executive Vice-President Phil A. Erli.

This rising tide of telecom spending could lift many ships. Startups such as Calix, Kasenna, and Ikanos Communications were founded to supply phone companies as the move to Internet-style gear. But the industry old guard may also benefit: Lucent Technologies, Alcatel, and Nortel Networks are likely to be tapped as prime contractors to oversee the roll out of new services. That would be sweet relief for the long-suffering.

—By Peter Burrows in San Mateo, Ca

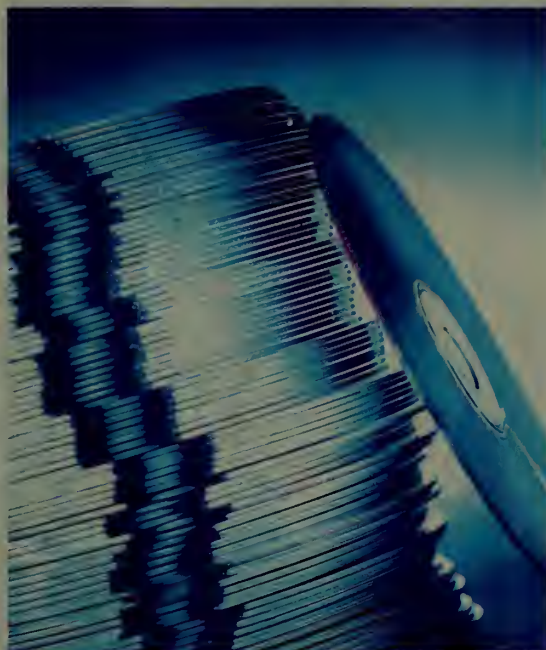
Expect the Giants To Stay Sluggish

Purchasing decisions are being delayed because of Sarbanes-Oxley and Microsoft

Open source is going after the business and putting pricing pressure on the titans

YOU'LL HAVE TO PARDON Marc Fleury if he's sounding awfully pleased with himself these days. Just three years ago, his company, JBoss Inc., was a struggling operation being run out of his parents' Atlanta garage. Today, tens of thousands of businesses have downloaded its software—used for running Internet applications. JBoss is part of a new generation of companies taking software into the open-source method into virtually every corner of the industry. In the process, they're making even the mightiest of old software titans nervous, since open-source software is typically much less expensive than what traditional companies sell. "Our business model is completely disruptive," boasts Fleury. Disruption is the last thing the software industry needs. Due to slack demand, the glory years of double-digit growth just keep on receding in the rearview mirror. Sales of new software licenses and technical support, ranging from the antivirus software that consumers pick up at the local electronics store to giant financial systems for multinational companies, will increase just 6% in 2005, to \$152 billion, predicts Gartner Inc. That's slightly higher than in the last couple of years, but it doesn't compare to the roaring 15% growth rate of the late 1990s.

Several factors are combining for yet another tough year. Delays of Microsoft's next PC operating system until at least 2006 have made some software buyers reluctant to purchase anything new, for fear it will be outdated when Microsoft finally delivers. And the time and expense of complying with Sarbanes-Ox-



ley financial reporting regulations is putting some big projects on hold. "Compliance issues are the biggest disruption to a return to normal spending," says Joanne M. Correia, an analyst at Gartner.

Of course, some companies benefit from the spending shift. Sales of software that helps companies deal with paperwork and business processes—a must-have in the new regulatory environment—are forecast to increase 15.5%, to \$875.4 million, this year. Sure, it's a tiny market when compared with the \$11.8 billion database-software market, which is expected to grow just 2% this year. But big companies such as SAP and Computer Associates International Inc. are taking

advantage of it. Likewise, security software spending, dominated by Symantec Corp. and computer networking giant Cisco Systems Inc., is projected to increase 13%, to \$5.6 billion.

Analysts expect sector leaders like Microsoft, Oracle, SAP, and Symantec to continue to gain share against second-tier competitors. At the same time, though, tech buyers looking for innovative designs are handing their business to groundbreakers. These newcomers include salesforce.com Inc., which rents customer management software like a service over the Internet, and Red Hat Inc., which distributes a version of the Linux open-source operating system.

IN FRUGAL FASHION

AT ONE TIME, it looked as if the effect of the open-source phenomenon on the software industry would be limited to Linux and a handful of other programs. But new companies are going after parts of the industry many felt would be untouched by open source. Take SugarCRM Inc. The Cupertino (Calif.) startup is tackling the industry giants that sell systems for customer relationship management. Likewise, Sourcefire Inc. in Columbia, Md., is selling software that detects hackers trying to break into computer networks.

Open-source software is putting major pricing pressure on traditional software suppliers. It's typically delivered in two different ways: One is free, with the company making its money by offering maintenance and support. That's what JBoss does, giving away its Net software and charging for services. The other is offering one version of the software for free and another, more capable version for a license fee. That's the business model of Sourcefire and MySQL, a company that sells an open-source database. Either way, the open-source model allows them to do

more with less money. And in this age of tech frugality, that approach seems guaranteed to win not just friends but customers—and bug the heck out of the industry's giants. ■

—By Jim Kerstetter
in San Mateo, Calif.,
with Steve Hamm in
New York

SPOTLIGHT



2005 PROSPECTS

C		Output Growth
		3.2%
Growth Trend*	3.8%	
Output	\$50 bil.	
Employment	250,000	

*Avg. yearly change, 1990-2004
Data: Economy.com (page 91) Grade: BusinessWeek



HARDWARE

Tightwad IT Buyers Loosen Up

» Healthy demand will keep sales of new computers on the upswing

» But remembering the slump, companies will favor smaller, cheaper systems

TECHNOLOGY IS LIKE oxygen to the folks at Sabre Holdings Corp., which runs the world's largest computerized airline reservation system.

But in the midst of a travel industry slump, Sabre's vaunted computer systems aren't exempt from penny-pinching. When it came time to upgrade key hardware last year, it bypassed pricey, proprietary servers and purchased cheaper off-the-shelf machines running hot new microprocessors. The results: Sabre saved as much as 80% on costs, yet got faster speeds. Says Chief Technology Officer R. Craig Murphy: "You want the price to go down and the performance to go up."

Such is life for tech buyers today. As the global economy slowly strengthens, corporations and consumers are investing in new tech gear again. But most haven't shed their post-bubble preoccupation with keeping spending in check. This

means that, for the next few years, revenue growth is going to come slowly in the computer hardware business. After a 4.8% gain in 2004, worldwide sales of PCs, servers, storage, networking, and peripherals should tick up modestly by 6.2% in 2005, to \$386.6 billion, according to research firm International Data Corp. (IDC). "There's still a little devil sitting on the shoulder of the IT manager," says IDC Senior Vice-President Crawford Del Prete. "It's saying: 'Before you go out and install hundreds of servers, think.'"

Smart devil. With customers unwilling to spend money on gear just to get the latest models or most recent version of Windows, the focus is moving to equipment that's both less expensive and more useful. Take Sabre's 140 new servers. They cost less to buy and maintain, in part because they run Linux, an open-source op-

erating system. But since they're designed around a 64-bit chip from Advanced Micro Devices Inc., they're able to handle complex tasks such as quickly searching through millions of domestic airfares. At the lowest price, a job that earlier-era servers never could have handled. Sabre is looking to move its international fare-search engine to a similar system.

That outlook is one reason there are differences in growth among the various slices of the server market. Overall, the hardware segment's growth will be 6.2% to \$53.7 billion. Linux servers, though, should see a hearty 26% sales jump, while servers running Windows will grow 11%, according to market forecaster Gartner Inc. Meanwhile, mainframes and supercomputers, based on proprietary versions of Unix, mainly from Hewlett-Packard, IBM and Sun Microsystems Inc.—should see sales continue to shrink. That's partly a result of higher price tags.

So 2005 could be the year that Linux servers finally cede their market to machines running Microsoft Corp.'s Windows. Gartner forecasts that Windows servers this year will grab 30% of spending, compared with Unix's 23% and Linux's 11%. Soon, says Kevin Johnson, Microsoft's head of sales, it's going to be a game of "Windows vs. Linux."

SMALL IS BETTER

SIMILAR FRUGALITY suffuses the storage age business. Undeniably, there's a demand for more capacity. A recent survey of 80 companies by Sanford C. Bernstein & Co. found they had, on average, 25% less data storage space than they need. But to fill this gap, companies increasingly are opting for cheaper hardware that comes in smaller building blocks. This gear typically gets less critical data, such as old e-mails that can be archived under Sarbanes-Oxley regulations. IDC says overall storage sales will notch just a 5% gain, to \$27.3 billion. Annual sales growth in midsize storage systems should be two to three times greater than in high-end hardware.

predicts Bernstein analyst Toni M. Scognaghi. "That trend is inexorable," he says.

Across the hardware industry, intense competition and component cost pressures are constantly putting prices down. For now, look no further than the PC sector,

SPOTLIGHT



2005 PROSPECTS

A

Output Growth
7.6%

Growth Trend*	3.4%
Output	\$46 bil.
Employment	270,000

*Avg. yearly change, 1990-2004
Data: Economy.com (page 9) Grade: BusinessWeek

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punishing price wars have only accelerated consolidation. Most recently, IBM agreed to hand off its legendary PC business to China's Lenovo Group Ltd., a company with lower costs and global ambitions. The deal would form the world's third-largest PC player, with about 9% of the market, and extend Lenovo's market lead in China, one of the few remaining growth areas for PCs.

SOFA STRATEGY

THE TIMING OF THIS deal is tricky, however. By the time it closes in midsummer, many companies will have purchased new PCs to take advantage of wireless networking and other tech advancements. All told, PC spending will grow just 4.1% in 2005, to \$168.9 billion, predicts IDC.

There are still some sunny spots on Planet PC. The longtime dream of convergence between computing and consumer electronics is finally a reality. After years of effort, PCs based on Microsoft's media center software are showing signs of acceptance. More than 1 million such models have been sold, allowing users to control the PC and whole entertainment systems by remote from the sofa.

PC giants hope the jazzy new media centers will offset slowing home PC sales and become the beachhead they use to sell everything from plasma TVs to digital music players. Even better, media centers are selling for an average of \$1,300 apiece, twice the price of plain-vanilla desktops, according to NPD Group Inc. The PC camp will have to contend with a resurgent Apple Computer Corp., still enjoying success with its iPods and basking in praise for its iMac G5 desktops. "The consumer market's going to feel like the Wild West," says IDC's Del Prete.

The business market is much bigger, though. That's one reason Dell Inc., which concentrates on corporate customers, was able to push its overall PC market share to 18% in the third quarter, up from 16% the year before. Among gadget-happy professionals, the hottest thing will be phone and personal digital assistant combos; sales of these smart handhelds should jump 43.5%, to \$16.3 billion.

Economic pressures are easing, there's plenty of cash on the books, and tech executives are more optimistic than they have been in four years. But the bitter memory of the tech wreck lingers, leaving everyone cautious about how much to invest in new hardware. "The engineer in me isn't necessarily always happy," says Sabre's Murphy. But his inner bean-counter? Ecstatic. ■

—By Andrew Park in Dallas

CONSUMER ELECTRONICS

No End in Sight to the Honeymoon with Digital

Forget toys for tots. Tech toys for the older set are so hot that even Web portal Yahoo! Inc. is getting in on the act. In December, it unveiled a line of DVD players and home-theater systems bearing its name. The field is becoming crowded with consumer-electronics companies, PC companies, and even retailers like Wal-Mart Stores Inc. and Best Buy Co. selling branded wares as they take



advantage of standardized digital components and cheap contract manufacturing from Asia. It's no wonder 2004 U.S. consumer-electronics sales zoomed past expectations of a 4.2% gain to finish the year up 8%, at a record \$108 billion. "There's a love affair that Americans have with our products," says Gary Shapiro, president of the Consumer Electronics Assn.

That love is still in the honeymoon phase. Thanks largely to soaring sales of digital music players and big-screen digital TVs, industry revenues are expected to jump an additional 7% in 2005, to \$116.5 billion, according to CEA projections.

Much of the action is in the family room. U.S. sales of big-ticket flat-panel TVs are poised for a banner year. Unit sales of both

plasma and liquid-crystal display sets are expected to nearly double, to 5.4 million, the likes of Samsung, Sony, and Sharp boost manufacturing capacity. The competition will cause prices of some models to slip below \$2,000 by yearend, industry watchers say.

For portable electronics, there's plenty room to grow and some very hot categories. Digital camera sales have surpassed traditional film cameras in popularity, with 53 million units sold in 2004, according to researcher InfoTrends/CAP Ventures. That number is projected to continue to rise, to 82 million units in 2008, as first-timers go digital and current users trade up to higher megapixel versions.

Thanks to the success of Apple Computer's iPod digital-music player line, which has increased awareness of the category, portable audio player sales will top \$1 billion for the first time, the CEA estimates. And notebook PCs increasingly are adding entertainment components such as wide screens and the ability to record TV shows.

One of the biggest consumer electronics battlegrounds will be games. On the handheld side, Nintendo beat rival Sony to market in the U.S. with its Nintendo DS (dual-screen) console. It was expected to sell 1.4 million units in 2004. Sony's Play-

Station Portable handheld scheduled for release in the U.S. and Europe by this March, and researcher InfoStat/MDR predicts consumers will snap up 7 million units by the end of this year.

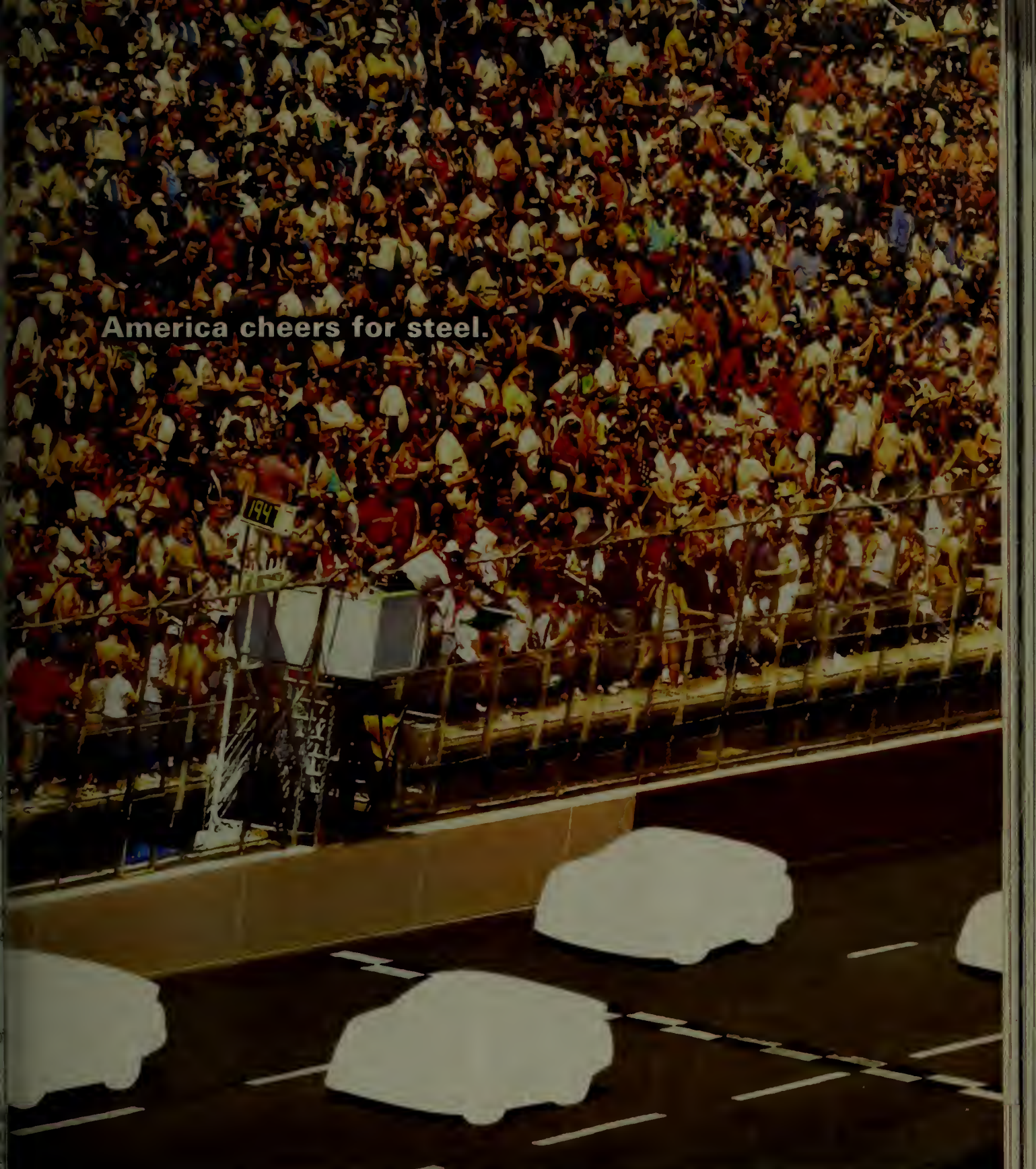
In consoles, Microsoft Corp. plans to release its next-generation Xbox in the

fall of 2005, as much as a year ahead of Sony's new PlayStation 3 and a Nintendo GameCube successor. Sony is betting it can get more mileage out of PlayStation. It has shipped about 80 million units of that platform and aims to extend the unit's life by cutting prices and slashing size in a major redesign.

As the gizmos multiply, prices fall, and the market grows ever more competitive, consumers are the sure winners.

—By Cliff Edwards in San Mateo, Ca

Demand is still climbing for everything from cameras to PDAs to music players



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CHIPS / COMMENTARY

The New Driver in Chipland

Now consumers are propelling industry growth as semiconductor smarts become a must in everyday devices and newfangled gizmos. >> BY SPENCER E. ANT

FOR THE semiconductor industry, 2004 was a watershed year. No, not because the chip market reported its second year of double-digit growth, hitting record revenues of \$217 billion. Not even because scrappy Advanced Micro Devices Inc. knocked mighty Intel Corp. on its rear. Rather, 2004 was a milestone because, according to the Semiconductor Industry

Assn. (SIA), sales of chips for consumer devices were greater than sales for corporate gear for the first time in industry history. Yes, in 2004, the consumer became king in chipland. And the regime change presents many challenges.

Look around and it's easy to see the consumer influence. Digital cameras, DVD players, and digital music players like Apple Computer Inc.'s hot-hot-hot iPod are all wildly popular consumer gadgets that didn't even exist until a few years ago. What's more, longtime necessities such as your car and relatively new ones like your cell phone continue to sprout features requiring additional semiconductor smarts. The rise of the consumer as the driver of chips—and the tech industry overall—will only accelerate as gadgets proliferate like mushrooms in wet grass and a few billion Asian consumers use their fattening wallets to purchase PCs, cell phones, and a host of other digital doo-dads. "The consumer is really driving the semiconductor market," says Gary Grandbois, analyst with El Segundo (Calif.) research firm iSuppli Corp.

The trend has important implications. It means the health of the chip sector will be tied more to macroeconomic forces such as oil prices and interest rates than to the state of corporate capital spending. It's also the latest sign that the industry's balance of power continues to shift to Asia as Chinese and Indians become major consumers of technology.

The rise of the consumer is also disrupting the competitive dy-

namics of the tech sector as electronics titans revamp their strategies to chase growth in the consumer market. Witness Hewlett-Packard Co. partnering with Apple to sell digital music players and rivals Sony and Samsung Electronics teaming up to produce digital TV chips. Expect more unusual consumer-driven partnerships. And don't be surprised if PC makers such as HP and Dell sell more consumer products such as cell phones. Morales, vice-president at research firm IDC, says the success of many technology companies in the future will hinge on their ability to jump on the consumer bandwagon. "Companies that don't have the scale to build a supply chain around consumer products will be killed," he says.

For all the hubbub, the industry is expected to slow somewhat

in 2005. That's partly because millions of consumers have already upgraded their phones and PCs in the past two years, and partly because the price of silicon power is falling. Forecasts for chip industry revenue in the next year range from modest growth to a decline of 5% to \$207 billion, according to Semiconductor Research Corp. in Phoenix, Ariz.

A cooling market means slower



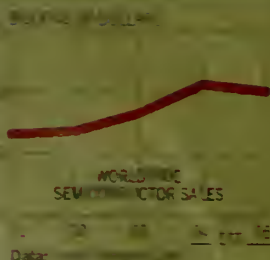
growth and even lower profit growth for the industry's leaders. Intel's sales are expected to grow 7% this year, down from 13% in 2004, while the chip giant's net income is projected to tick up 2% after a 43% surge last year. Texas Instruments Inc., a specialist in cell-phone and media chips, is expected to boost sales 6%, down from a torrid 28% spurt last year.

Amid the pullback, a few consumer markets will continue to shine. Chip sales for digital cameras are expected to surge 3% while digital TV chips are forecast to swell 27%. Later this year, some PC users will also spring for PCs with "dual core" chips—two separate processors on a single chip—that are more powerful but require less power than traditional computer chips.

The convergence of different technologies also forces manufacturers to think more about ordinary users. Video will sprout on cell phones. New game consoles from Sony and Microsoft Corp. will include wireless networking capabilities. And a wireless technology called near field communication will transform your cell phone into a credit card. All these applications vindicate chipmakers who took a step back from the corporate market and placed their bets on consumers. ■

SPOTLIGHT

2005 PROSPECTS



C Output Growth 2.4%

Growth Trend*	14.2%
Output	\$189 bil.
Employment	464,000

*Avg. annual growth rate, 2000-2004
Data: iSuppli Corp. and the U.S. Bureau of Economic Analysis

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DRUGS

More Bitter Pills For Big Pharma

Patents are expiring on blockbuster drugs, and there's not much in the pipelines

Executives fear that Washington will get tough in the wake of the Vioxx debacle

LAST YEAR, MERCK & CO. made pharmaceutical history as the company that suffered the greatest agony due to a pain remedy. In September, Merck withdrew Vioxx, its \$2.5 billion pain medication, after a study confirmed fears that the drug raised the risk of heart attacks.

Within weeks, Merck had plenty of company: A study linked Pfizer Inc.'s Celebrex to heart problems. Eli Lilly & Co. was mired in potential liver problems with Zelnorm, a drug for attention-deficit hyperactivity disorder. AstraZeneca PLC disclosed that its Zoladex, a lung cancer treatment, might not extend patients' lives. Crestor, a cholesterol-lowering drug from the same company, fell under scrutiny for potential side effects. By the end of the year, all this heat was battering pharmaceutical company valuations and misting future prospects for drug stocks.

The current year is unlikely to mark a return of robust health for the drug sector. A preliminary estimate from business information and consulting firm IMS Health shows drug sales in the U.S. to be up 9.5% this year, to \$259 billion. That's a tad better than 2004, with estimates showing sales rising 9%. But it's

hardly a stellar performance: The industry hadn't posted single-digit growth since 1994.

The challenges in 2005 are similar to those the industry faced last year. Patents on major drugs continue to expire. At the same time, executives worry that the Food & Drug Administration could turn overly cautious in approving new drugs in the wake of Vioxx. That would be bad for an industry already struggling through a period of weak output from research labs. "The erosion from generics is large, and the contribution from the innovation engine is lower than it used to be," warns Schering-Plough Corp. Chairman and CEO Fred Hassan.

That is not to say innovation has ground to a halt. Pfizer is expected to launch two important drugs in the U.S. market in 2005: Macugen, a treatment for

while pharmaceutical executives continue to face challenges from counterfeit versions of their branded drugs, there are signs of progress. India, for example, will be implementing patent protections for new pharmaceutical products in 2005. "At least we will be getting the full [benefit] of our innovation instead of splitting it with a dozen copycat companies," says Glaxo-SmithKline PLC CEO Jean-Pierre Garnier.

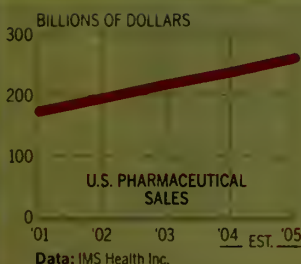
WASHINGTON WATCH

THE INDUSTRY NEEDS to wring every buck it can to offset the loss of some big sellers as more patents expire. On the hit list in 2005: Pfizer's \$2.1 billion antibiotic, Zithromax, and Johnson & Johnson's \$2.1 billion painkiller, Duragesic. And investors will be nervously watching a court case brought by Indian generic drugmaker Ranbaxy Laboratories Ltd., which seeks to knock down key patents on Pfizer's \$10 billion cholesterol-lowering drug, Lipitor. While analysts say Pfizer has a good shot at prevailing, the outcome is far from certain.

Drug industry watchers are focusing on the regulatory environment in Washington as well. With the public outcry over drug prices continuing to mount, Congress is likely to return to the issue of reimporting drugs from Canada. But analysts say that even if a law were passed to facilitate such purchases, the impact on company bottom lines would be minimal.

In contrast, regulatory fallout from the Vioxx debacle poses a substantial threat to business as usual. Lehman Brothers Inc.

SPOTLIGHT



2005 PROSPECTS

C+ Output Growth 2.9%

Growth Trend* 3.2%
Output \$53 bil.
Employment 305,000

*Avg. yearly change, 1990-2004
Data: Economy.com (see page 10) Grade: BusinessWeek

macular degeneration that Pfizer will market with Eyetech Pharmaceuticals, and Lyrica, an epilepsy and pain medication. Some forecasters are also excited about Eli Lilly's new urinary incontinence drug, Yentreve, which is expected to win FDA approval in the first half of the year. And

analyst Rami Armon says the FDA may crack down harder on drug companies' aggressive direct-to-consumer advertising. And he figures the agency may also be more assertive about putting strong warnings on drug labels when safety questions arise, something drug companies resist because it can hurt marketing. Indeed, the FDA has already slapped stronger warnings on several drugs, including Pfizer's Bextra, a painkiller in the same class as Vioxx. "The wild card is the FDA," says Murray L. Aitken, senior vice-president for corporate strategy at IMS Health.

"MORE RISK-AVERSE"

INDUSTRY EXECUTIVES also worry about how the FDA will treat new drug applications in '05. They fear regulators may become too stringent on safety when reviewing novel treatments. "In the past, people accepted there was no such thing as a totally safe drug," says AstraZeneca

CEO Sir Tom McKillop. "Today, we have become more risk-averse."

All these pressures make it more critical than ever that drugmakers improve their dangerously weak development pipelines. That's why investment bankers say Big Pharma companies will pursue licensing or acquisition deals with smaller companies more aggressively than ever to get their hands on upcoming products. Lazard LLC investment banker Steven J. Golub says intense competition for those products means deals are now getting done more quickly.

In the past, drugmakers were inclined to license many products when they reached the final phase of human testing. Now, in the rush to license, drugmakers seem willing to sign deals at a point early in the testing process, when drugs run a higher risk of failure. As for important mergers, many bankers say weakened companies such as Schering-Plough, Merck, and Bristol-Myers Squibb could

be acquisition targets. But given the companies' patent or legal problems, some potential partners may be inclined to stay on the sidelines for now.

With new products flowing at a trickle, look for drugmakers to continue pushing for price increases in 2005. Sanford Bernstein & Co. analyst Richard T. Bernstein expects pharmaceutical prices to double the rate of inflation this year. Why? Drugmakers may feel there's a political downside with a Republican-controlled Congress and White House. They also recognize that pricing will become much more difficult after the final government phases in its Medicare prescription-drug benefit in 2006, but Washington is likely to push hard to take a lid on costs. Another reason there are winds for Big Pharma, in the longer run, aren't going to abate. ■

—By Amy Barrett in Philadelphia
with John Carey in Washington
Michael Arndt in Chicago

BIOTECH

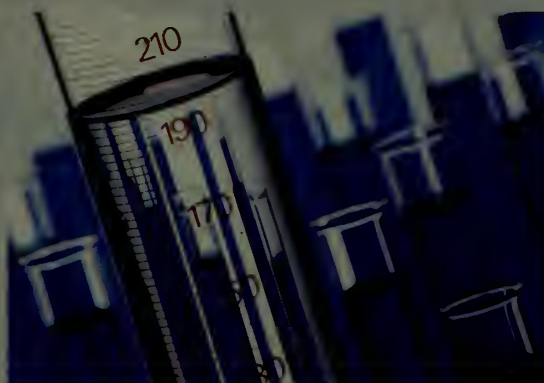
One Sector With Strong Vital Signs

Surveying the biotech landscape at the close of 2004, Genzyme Corp. Chief Executive Henri A. Termeer called recent events in the drug and biotechnology industries "disquieting." That's an understatement. On top of the infamous Vioxx debacle, AstraZeneca's problems with Iressa, and other flare-ups over drug safety and efficacy, Chiron Corp. suffered a mortifying manufacturing glitch at its flu vaccine plant in England, leaving the U.S. with only half the inventory it needed for the winter. All these stumbles left biotech investors fearful about a tougher regulatory environment for drugs and manufacturing processes in 2005.

Are the worries legitimate? The Food & Drug Administration may well impose harsher safety requirements, but that doesn't mean people are going to spend any less on biotech drugs and vaccines. Ernst & Young International predicts that revenues for publicly traded biotechs will rise to \$51.4 billion in 2005, up 19.5% from the total it forecast for 2004. One potential hit: the

recently approved multiple sclerosis treatment called Tysabri, jointly marketed by Biogen Idec Inc. and Elan Corp. New insomnia and cancer treatments are also on the near horizon.

On the research front, more private money



is now flowing into promising work in embryonic stem cells. The field got a huge boost in November when California voters approved a 10-year, \$3 billion stem-cell initiative, and other states may follow later this year.

As biotechs unveil breakthroughs in stem cells and other areas, they should attract more funding from pharmaceutical companies whose research pipelines are

dry. Through early December, 2004, drug companies inked 451 licensing and investment deals with biotechs, compared with 314 in 2003, according to the Biotechnology Industry Organization (BIO), and the trend seems to be upward.

Such activity helps stoke investor interest. In 2004 companies raised \$19 billion in public and private offerings, up from \$14.9 billion in 2003, according to BIO, and 2005 could show similar results. VentureOne, a venture-capital research group, says the ability of VCs to "exit" the biotech investments via initial public offerings has been good over 2004, and that's a decent predictor for the coming year. But not just any startup will do, says Buck Phillips, managing director of Vector Fund Management LP: "Investors have shifted away from high-risk names and are looking for more mature companies." Jim Tullis, CEO of VC firm Tullis-Dickerson & Co., figures the Amex Biotech Index could rise more than 10% in the coming year.

Certainly the industry faces challenges. Patients and doctors are increasingly critical of new biotech cancer treatments that can cost as much as \$10,000 a month. "The public is saying we don't want to pay a lot of money for drugs that won't importantly improve our health," says Burt A. Adelman, executive vice-president for development at Biogen Idec. Nevertheless, barring any drastic steps by the FDA, it's reasonable to expect new drugs, more funding, and fair returns in 2005.

—By Amy Tsao in New York

More Money, Less Care

Higher outlays aren't getting the U.S. a better health-care system, but the feds aren't doing much to redress this miserable equation **>> BY CATHERINE ARNST**

THIS IS WHAT passes for good news in health care: U.S. spending will increase by only 9% to 10% in 2005, about the same rate as last year, according to UBS Securities. That's still three times the rate of inflation, but at least it's less than the gains the nation saw in the first two years of this century, when costs rose by 12% to 13% a year.

All told, the U.S. will probably spend an estimated \$1.9 trillion on health care in 2005, \$100 billion more than the prior year. That's 15.7% of the gross domestic product. Despite such enormous sums, hospitals will continue to struggle to stay afloat, employers will continue to face higher insurance premiums, employees will continue to shoulder a higher percentage of those premiums, and insurers—well, insurers will continue to do very well, thank you, because they get to pass their higher costs to the policy holders. Though not, of course, to the 45 million people who are uninsured—15.6% of the population.

At some point, and probably in the not-too-distant future, the level of spending will almost certainly become unsustainable. Expensive new drugs and medical technologies, a growing number of uninsured, and an aging, overweight population virtually guarantee cost increases will climb back to the 12% to 13% range in a few years. By 2010, UBS Securities estimates that health care will consume 17.4% of the GDP. "In my view, the pressure is not off costs at all," says William McGeever, a UBS health-care analyst. "I see nothing on the horizon that will moderate increases."

All of this might be O.K. if we were getting maximum bang for all those bucks, but we're not. Other industrialized nations, which have universal health coverage, spend less of their GDP

on health care—8% to 10%. Yet they rank well above the U.S. in average life expectancy and infant mortality rate, standard measures of a nation's health. The U.S. ranks in the bottom quartile of all industrialized nations on those two measures.

Nor does the U.S. do well on more specific quality measures. In a study of a broad range of procedures in five highly industrialized nations, released last spring in the well-regarded journal *Health Affairs*, researchers determined that the extra spending on health care in the U.S. is "not buying better experiences with the health care system, with the exception of shorter waits for nonurgent surgery." That conclusion was backed up by a study released in December by Veteran's Administration researchers: They found that only 51% of patients

nationwide receive medically recommended care for their conditions. So much for the oft-heard claim that the U.S. has the best medical system in the world.

Despite this dire situation, there are no serious proposals in Washington to redress the miserable cost/quality equation. President George W. Bush's main health-care reform initiative, the introduction of tax credits for Health Savings Accounts, is likely only to siphon off



healthy adults from existing insurance plans, making it harder to offset the costs of treating the sick. At the same time, the shift to high-deductible policies by many employers is likely to cause some consumers to delay health care until their conditions become serious—and more expensive to treat.

If change is going to come, it needs to be driven by the companies now picking up the nation's health-insurance tab, as well as their beleaguered employees. The annual Towers Perrin Health Care Cost Survey predicts that employers can expect, on average, an 8% increase in health-care costs in 2005, to an annual rate of \$7,761 per employee. Those employees will see their share of insurance premiums increase by an average of 14%, while benefits will be reduced by 2%.

A Henry J. Kaiser Family Foundation survey found that the cost of job-based health coverage has risen 59% since 2000, while the percentage of U.S. workers who receive health benefits through their jobs has dropped from 65% to 61%. Paying more, getting less. Isn't it about time that policymakers—and the people who vote for them—come up with a better way? ■

POTLIGHT

2005 PROSPECTS



B+

Output Growth
3.3%

Growth Trend*	2.5%
Output	\$603 bil.
Employment	14,582,000

*Avg. yearly change, 1990-2004
Data: Economy.com (page 91) Grade: BusinessWeek

SERVICES



There Goes The Gravy Train

Rising interest rates and inflation will probably leave consumers with less to spend

Deep discounters such as Wal-Mart will keep the price pressure on rivals

AFTER PACKING their closets with new clothes, super-sizing their TVs, and fueling their SUVs with costly gas for the past year, Joe and Jane Consumer are getting tapped. "The real question," says Standard & Poor's Chief Economist David A. Wyss, "is can consumers keep it up, given that you're already spending all they have?" The answer: not the way they have now. In the new year, total U.S. sales will grow, but far more slowly than last year, as consumers rein in their spending in the face of rising interest rates and nascent inflation. Retailers will sell \$1.06 trillion worth of general merchandise, apparel, furniture, and other products (excluding autos and food). That's 3.8% more than last year, predicts Standard & Poor's, which, like *BusinessWeek*, is a unit of The McGraw-Hill Companies. Not bad, but it's well below last year's 6.2% increase in 2003.

Rising interest rates are already beginning to bite into spending. The percentage of disposable income that U.S. households devote to service mortgage and consumer credit crept to 13.32%, near its all-time high, at the end of the third quarter. With

the benchmark federal-funds rate expected to climb from today's 2.25% to 4% by yearend, consumers' variable-rate credit-card balances and mortgages will track upward, too, eating up more cash. At the same time, higher rates will slow home-mortgage refinancings and home-equity loans, pinching off a source of spending that in recent years has fueled countless renovations—and growth for the likes of Home Depot Inc. and Lowe's Cos.

Impending inflation, led by energy prices, may also dampen spending. The 20% increase in gas prices in 2004 left drivers with less to spend. And while energy prices are expected to moderate in the new year, problems in the Mideast, or a demand spike, could send prices skyward. Each 10% increase in the year-over-year gasoline price knocks about a third of a percentage point from chain stores'

sales growth, according to the International Council of Shopping Centers. That's a big hit when many chains struggle for just 2% to 3% growth. As retailers adjust to this new consumer reality, they face a familiar foe in the form of Wal-Mart Stores Inc. The giant continues to push prices relentlessly downward, affecting retailers in other markets. "Even the Neiman Marcus shopper occasionally buys socks or sweatpants from Wal-Mart," says S&P retail analyst Marie Driscoll. With 295 new or expanded Wal-Mart stores and Supercenters scheduled to open in 2005, the Bentonville (Ark.) giant will further extend its reach through the year.

LUXURY SLUMP?

AMONG THE FEW able to outflank Wal-Mart have been "dollar stores" such as Dollar General Corp. and Dollar Tree Stores Inc., which have managed to undersell the juggernaut by stocking huge amounts of cheap goods, including discontinued merchandise, often sold for \$1 or even less. When Wal-Mart fails to slash

prices enough on fast-moving merchandise such as DVD players, sales suffer—as they did in the past holiday season.

At the high end of the retail market, luxury retailers such as Coach Inc. and Neiman Marcus Group Inc., which prospered in 2004, will find this year less robust. Middle-income consumers who might have splurged in recent years will be less likely to do so now. These stores' wealthy customers face falling stock re-

turns as interest rates rise.

In the middle market, the outlook is mixed. In the first part of the year, specialty apparel chains such as Gap Inc. face tough comparisons with the first quarter of 2004. Then, the early arrival of spring weather fueled full-price clothing pur-

SPOTLIGHT



2005 PROSPECTS

B

Output Growth
5.3%

Growth Trend*	4.7%
Output	\$674 bil.
Employment	12,410,000

*Avg. yearly change, 1990-2004
Data: Economy.com (see page 91) Grade: BusinessWeek

sales growth, according to the International Council of Shopping Centers. That's a big hit when many chains struggle for just 2% to 3% growth.

As retailers adjust to this new consumer reality, they face a familiar foe in the form of Wal-Mart Stores Inc. The gi-

chasing, says Wells Fargo Securities retail analyst Mark Montagna.

Meanwhile, retailers of all stripes are pushing forward with cost-cutting strategies, and coming up with new ways to stock distinctive merchandise. Many stores are rolling out higher-quality private-label lines, notably in the crucial women's apparel segment. With private-label goods, stores can undercut national name brands yet still make a healthy profit. As health-care and energy costs inch upwards, retailers will work to cut inventories to prevent margin-eating markdowns and continue to find savings in areas such as payroll costs by using part-time workers.

For those who can't master these tricks, bankruptcy looms. Financially troubled chains ranging from teen retailer Gadzooks Inc. to Kmart Corp. will continue to close stores. But that won't necessarily lessen the unrelenting competition in the industry, both online and offline, from new and fledgling retail concepts. "There's constant segmenting with new stores," says Montagna. Abercrombie & Fitch Co., for one, recently launched Ruehl, a clothing chain aimed at women in their twenties.

ONLINE FALLOFF

ONLINE SALES GROWTH will continue to outpace traditional retailers, but by less than in recent years. JupiterResearch, in Darien, Conn., estimates that e-commerce sales, excluding autos and travel-related transactions, will rise 19%, to nearly \$80 billion, in 2005—about 4% of all retail sales. That's a healthy increase, but it's lower than 2004's 25% rise, in part because the number of customers new to the Web is shrinking. Sales at the market-leading e-tailer Amazon.com, for example, are forecast to grow by 19%, to \$8.1 billion, in 2005, down from a 30% rise in 2004.

E-tailers are confronting many of the same challenges as their traditional competitors. In the past, they could count on picking off customers from bricks-and-mortar stores. No longer novel, Web retailers attract fewer defectors these days and instead increasingly "compete with one another for existing customers," says Jupiter analyst Patti Freeman Evans. That's partly because the quality of the shopping experience is improving at bricks-and-mortar retailers. As the bar rises, e-tailers and real-world stores alike will be chasing choosier shoppers with fewer dollars. ■

—By Louise Lee in San Mateo

MEDIA

New Generations Steal the Show

» Most traditional types of media will give up share to a New Media rival

» Companies are likely to consolidate as they scramble to stay on the cutting edge

YOU KNOW THE MEDIA business has gotten wacky when Howard Stern is being hailed as a savior. In signing the shock jock to an extraordinary \$500 million five-year contract in October, subscription-based Sirius Satellite Radio Inc. signaled its intention to remake the face of U.S. radio. So far, the \$21 billion broadcast radio industry isn't feeling any immediate threat: Sirius and its larger rival, XM Radio, have signed up only a little over 3 million subscribers, at monthly rates of \$12.95 and \$9.99, respectively. Even so, Stern's defection is considered a watershed event in the rapidly changing media world.

By all indications, 2005 will be a year in which just about every traditional media company gives up market share to some next-generation rival. Cable-TV operators will continue to lose subscribers to satellite, and perhaps even to telephone companies. Networks will see even more eyeballs defect to cable. And despite lawsuits and legal download sites, the music industry will still confront more illegal downloads.



The challenges come in all shapes and sizes. Broadcast networks will look like they're zapped by a rising army of remote-wielding couch potatoes with digital video recorders (DVRs). Film studios will see more movie-loving teens in the neighborhood cineplex for games and DVDs—some of which play on new hardware platforms such as the Sony PlayStation Portable, hitting the U.S. this spring. "Everywhere you look, it gets harder for a media company

to grow its original business," says Yoram Yemini, chairman of Goldwyn-Mayer.

One immediate result of the turn of consolidation is that itself was sold recently to a USA-led consortium and more such are inevitable.

SPOTLIGHT



2005 PROSPECTS

B+	Output Growth 2.3%
Growth Trend*	1.1%
Output	\$187 bil.
Employment	1,948,000
*Avg. yearly change, 1990-2004	
Data: Economy.com (see page 91) Grade: BusinessWeek	

only way they can grow," Yemenidjian. Indeed, with the rise of cable and satellite behemoths such as Comcast and Rupert Murdoch's DirecTV, the pressure for rivals to merge will rise. Krupt Adelpia Communications is expected to be auctioned off in with its systems likely being divvied between Comcast and Time Warner. die Erge's EchoStar Communications Corp. satellite service also may be on block, says UBS Warburg analyst h Bourkoff, who figures Comcast t buy a film or TV studio to beef up deo-on-demand business.

nd after a tumultuous 2004, expect e drama at Walt Disney Co. By June, esieged board is expected to name a essor to CEO Michael D. Eisner; earlds favor Disney President Robert A. but support is growing for both Via- Inc. Co-President Leslie Moonves News Corp. President Peter Chernin. victor will have to deal with the Pixar or. Disney's 13-year alliance with e P. Jobs's blockbuster factory, Pixar nation Studios, has expired. Jobs has d the waters with Warner Bros. and Entertainment Group Inc. But insid- ay he'll wait to make a deal with the essor to Eisner, with whom he has ed over sequels in the past.

DVR THREAT

IA COMPANIES THAT depend on rtising also will see shifts in a market ill grow by 6.4%, to \$280.6 billion, icts Universal McCann forecaster ert J. Coen. The biggest increases will o booming, ad-driven businesses on et, such as Google Inc. and Yahoo! at both the Olympics and the pres- tial race are over, ad revenues at the Four TV networks will grow only 2%, 16.8 billion, predicts Coen.

art of the problem is competition n cable and from video games. These on off viewers of network TV, damp- g rate increases. Another potential n is the rise of ad-skipping DVRs, se installed base is expected to double oughly 11 million, or about 10% of TV eholds, estimates Forrester Research rincipal analyst Josh Bernoff. To find rowth, TV execs will load up on prod- placements.

ne rise of the DVRs also will accelerate rend toward consumer customization nertainment channels—never a good r for the networks. DirecTV will offer o magazines, allowing viewers to see al news or sports channels at once on screens. That and cut-rate prices will

help DirecTV and EchoStar subs continue to grow, jumping 12%, to \$27.7 million, according to digital forecaster Carmel Group. To compete, cable will roll out services satellite can't offer, adding 1.5 million customers of cable-based telephone services and 4 million high-speed data users, says analyst Jea Shim at Tradition Asiel Securities Inc.

Elsewhere in media, there will be an emphasis on new markets. Networks will begin offering content for mobile devices, such as Fox's planned one-minute versions of its TV series, 24, for cell phones. The music industry should sell more than \$3 billion in music ringtones for cell phones worldwide, Warner Music Group

Chairman Edgar Bronfman Jr. recently told investors. "We're no longer confined to the TV and the movie screen," says Sony Pictures Entertainment Chairman Michael Lynton. "We can't be."

But media giants are taking no chances: Several are likely to buy companies in the \$8-billion-a-year video game software business, following Warner's acquisition of Monolith Productions. Viacom probably will buy Mortal Kombat maker Midway Games. Another studio could buy Activision Inc., known for its Tony Hawk skateboarder games. It's the Hollywood way: If you can't fight 'em, buy 'em. ■

—By Ronald Grover in Los Angeles, with Tom Lowry in New York

ADVERTISING

Why Big Bucks Are Chasing Targeted Media

In advertising, 2005 will be the year of the sharpshooter. With consumers harder to reach than ever, ad spending on targeted and easily measured media is outpacing outlays for older, less focused media forms. Internet advertising will surge 25%, says Universal McCann. Direct mail should grow by 9.5%, the magazine sector by 7.3%, and cable TV by 7%. Mass media isn't where the action is: Radio ads, billboards, and other outdoor media will

Olympics. But major advertisers—especially in autos, financial services, and household products—are under pressure to boost market share. That means more spending on marketing, particularly campaigns with highly targeted messages. "Marketers have been hoarding their resources while the need for greater marketing efforts keeps piling up," says McCann's forecasting chief Robert J. Coen.

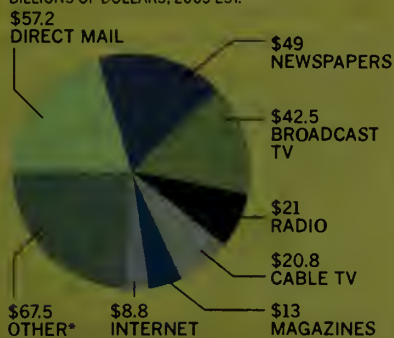
No one expects advertisers to become freewheeling spenders. The focus will be on return on investment (ROI). Indeed, CFOs are demanding big bangs from media budgets. Over the past decade, says Carla Hendra, president of direct-marketing agency OgilvyOne, companies have reengineered to reduce costs and improve accountability. "Now that has finally come home to marketing," she says.

Companies such as Ford and Procter & Gamble can't break their TV habit even as media prices climb and eyeballs get fewer. But they are increasingly keen to reroute money from easily-zapped 30-second ads into "product integration." Reality shows such as *The Apprentice* are being constructed around product placement. Indeed, among advertisers' hottest tools are those that figure out the ROI of paying to put M&Ms in Donald Trump's itchy hands, vs. advertising on his show. If placement demand keeps up, soon we could see networks saying "You're fired!" to 30-second spots.

—By David Kiley in New York

U.S. ADVERTISING MARKETS

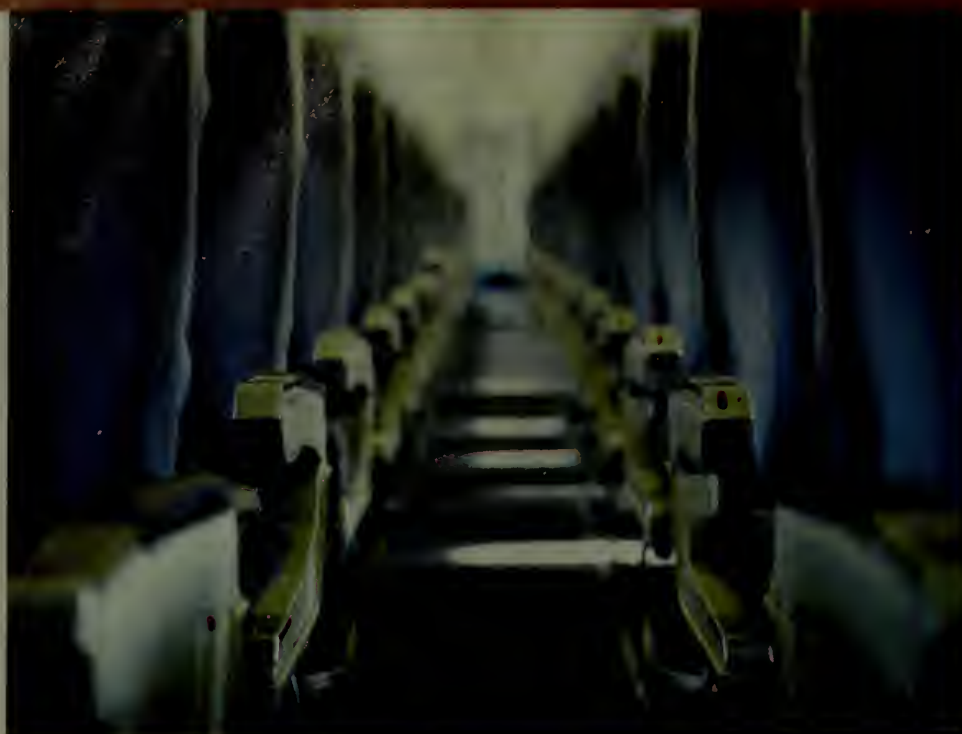
BILLIONS OF DOLLARS, 2005 EST.



*INCLUDES OUTDOOR SIGNAGE, YELLOW PAGES, ET AL.
Data: Universal McCann

grow just 5%, and network TV a scant 2%. Even with these laggards, however, McCann expects overall growth in ad spending to surpass that of gross domestic product for the second straight year, hitting \$280.6 billion, a 6.4% rise from 2004.

This year the industry won't see free-spending political campaigns or the



TRAVEL

Gray Skies Ahead—But More Will Fly

» Steep oil prices and overcapacity will keep bogging down airlines

» Travel is on the rise, perking up profits of hotels and car-rental companies

WHAT A ROTTEN year. Only Southwest, among the nation's top 10 airlines, earned a profit, while ATA and USAir joined

United in Chapter 11 bankruptcy. Mean-time, pilots at Delta, Northwest, and USAir were arm-twisted into cutting their wages, while thousands more employees were simply cut loose. In 2004, sighs W. Douglas Parker, chairman and CEO of America West Airlines, "we got a cold glass of water thrown in our faces."

As 2005 progresses, though, all the pain that airline workers and shareholders have endured may start to pay off. Granted, the airline industry is poised to lose money for the fifth straight year. ATA Air-

lines Inc. already has auctioned a good chunk of itself to Southwest Airlines Co., and US Airways Group Inc. is warning it may have to sell off its assets, too. And every old-line carrier is pressing workers for more givebacks with the threat of more layoffs. Yet if labor surrenders, giving back more pay and giving up pensions, many of the major airlines could restructure themselves into the black in 2006.

One good sign: Travel is finally perking up. Corporate America has told its road warriors to get back in the skies and drum up business. Leisure travel is on the upswing, too. After two down years, traffic at Walt Disney Co.'s resorts rose in 2004 and

analysts are boosting their 2005 outlook. Coming off a strong 2004, Hilton Corp. says higher occupancy and rates could swell its revenues per room 7% in 2005, raising earnings 25%. Dant Corp., which owns Days Inn and Ramada hotels, as well as car-rental companies Avis and Budget, also expects gains. In fact, hotel rates will increase 7.5% and rental rates will rise 5% this year as demand approaches 2000's peak, predicts the National Business Travel Assn.

LIGHTENED LOADS

SO WHY AREN'T airlines profiting? Record-high oil prices deserve much of the blame. With the exception of fuel, which is typically an airline's biggest expense, and fuel costs jumped 40% in 2004, to \$15.5 billion, says analyst Robert N. Baker of J.P. Morgan Chase. There's little chance that oil prices will fall significantly in the new year, according to Robert N. Ashcroft of UBS Securities.

Overcapacity is the industry's bane. Airlines expanded capacity by 10% more in 2004 as low-cost operators joined with entrenched majors for market share. And overall capacity should rise again in 2005, by as much as 4.5%—even money-losing discount carriers ATA and Independence Air Inc. disappear, Ashcroft expects. True, traffic is climbing, but not enough to give airlines leverage. The likely result is rock-bottom fares as carriers struggle to fill all the added seats.

Airline executives face some tough decisions. In addition to locking in fuel by hedging, each of the major airlines is trying to crunch costs further by reducing wages or headcounts. Northwest, which won a 15% pay cut from pilots in November, or \$265 million a year, now wants \$685 million in savings from everyone else. Delta aims to eliminate up to 7,000 jobs this year by pulling out of its Dallas-Fort Worth hub, eliminating 233 flights. United says it will drop 12% of its domestic schedule

in 2005.

Painful as the cuts should be, the old-line carriers are fighting a long run. All the while, barring a plunge in oil prices, 2005 will be another trying year for this long-troubled industry. ■

—By Michael
in Chicago

SPOTLIGHT



Data: Air Transport Association of America Inc., UBS Securities

2005 PROSPECTS

C+	Output Growth
	6.2%
Growth Trend*	6.5%
Output	\$714 bil.
Employment	13,334,000

*Avg. yearly change, 1990-2004

Data: Economy.com (page 91) Grade: BusinessWeek

Cleaning Up By Cleaning Up

Uncle Sam's crackdown
on fraud has been good for
auditors and lawyers

Consultants can expect
steady work from health-care
and government clients

AMERICA'S GRAY-suited ranks of accountants, consultants, and lawyers have Uncle Sam to thank. Increased government spending on consulting and new federal regulations on auditing proved a bountiful combination for professional services in 2004. And 2005 should see a repeat. For lawyers and accountants, the Sarbanes-Oxley Act continues to be a boon. Requirements for sharper audits, better informed board members, and tighter internal financial controls all play to professionals' strengths. *Inside Public Accounting* predicts global growth for all Big 4 accounting firms will be 9% to 12% fiscal 2005. The cost of a typical audit already jumped by up to 60% since Sarbanes-Oxley's passage in 2002. And provisions

that today apply only to the 4,000 largest companies will expand to encompass 10,000 more next year.

That's good news for firms large and small. Giant Deloitte Touche Tohmatsu, whose global revenue last year jumped 9%, to \$16.4 billion, has forecast a 7% climb in 2005. Grant Thornton LLP, a second-tier firm, did even better with a 23% revenue increase in the U.S. last year, and a 15% spurt is forecast for 2005.

But what has been good for audit firms hasn't been good for their clients' wallets, and companies are pushing back. In a 2004 study by Financial Executives International, companies with over \$5 billion in revenues reported spending an average of \$8 million each complying with Sarbanes-Oxley. Many complain there's not much value for all that spending. The backlash has been strong enough that Deloitte & Touche USA LLP CEO James H. Quigley has called for an assessment of the rules' costs and benefits after the

first year of compliance. "You just can't have clients this unhappy," he says.

Still, auditors' biggest challenge is to increase staff fast enough to meet demand. In the late 1980s and early 1990s, more than 50,000 accountants graduated each year in the U.S. But as college grads flocked to the tech sector and Wall Street in the late 1990s, interest in accounting as a career waned. In 2002, fewer than 35,000 degrees were awarded. That has climbed some in the years since, but not enough to match the rising demand.

Consulting isn't having the same growing pains. Growth there has been much more modest, but bright spots such as government and health-care consulting promise to keep the sector moving upwards in 2005. According to Kennedy Information Inc., which tracks

SPOTLIGHT



2005 PROSPECTS

B Output Growth 4.3%

Growth Trend*	3.5%
Output	\$851 bil.
Employment	10,787,000

*Avg. yearly change, 1990-2004
Data: Economy.com (page 9) Grade: BusinessWeek

the consulting industry, global revenues dropped 6% in 2002. But they grew 1% in 2003, an estimated 3% in 2004, and Kennedy projects another moderate rise in 2005.

Demand for professional-services outsourcing has been much stronger. Gartner Dataquest estimates that the worldwide outsourcing market, \$241 billion in 2004, will grow to \$324 billion by 2008. Some Asian firms have begun to move up the consulting food chain thanks to the outsourcing boom, with Indian firms like Infosys Technologies, Tata Consultancy, and Cognizant Technologies doing nearly \$2 billion of development and integration work in North America in 2003, according to Gartner.

International competition isn't the only pressure on profits. Clients increasingly are forcing firms into government-style competitive bidding that drives up the cost of getting new business, says Heather Burns, a Booz Allen Hamilton senior vice-president. Contracts are also getting shorter. And clients are demanding more evidence that their investment is generating a return. Still, consultants are happy to have the work. ■

—By Nanette Byrnes in New York



EDUCATION / COMMENTARY

U.S. Schools: Underperforming

The No Child Left Behind Act isn't doing the trick, and higher college tuition costs are squeezing out lower-income students **>> BY WILLIAM C. SYMONDS**

FOR EDUCATION reformers, the 21st century looked intoxicating. In 2001 Congress passed the No Child Left Behind Act to give the millions of low-income and minority children deprived of the American Dream a better shot. Meanwhile, a welter of for-profit companies promised to deliver more effective education across the U.S.



Yet today revolutionary rhetoric is giving way to some harsh realities. Peter J. Stokes, executive vice-president at Eduventures Inc., a Boston market researcher, says any hopes that for-profits might save America's public schools have faded since industry leader Edison Schools went private in late 2003. "And 2005 will be a critical year for for-profit colleges," he warns. A number, including Career Education Corp., are under investigation by federal authorities for, in some cases, overly aggressive student recruiting. Still, Eduventures predicts that, barring major scandals, the \$15.4 billion for-profit college market will grow 14%, because of demand for career-oriented courses.

For the \$500 billion K-12 industry, President George W. Bush's reelection means that public schools will have to focus on the mandatory testing No Child uses to hold them accountable. Granted, there have been some gains—but they aren't coming nearly fast enough to meet the goal of raising 100% of children to "proficiency" by 2014. Weak spots are already apparent. States including Texas and Colorado have simply made it easier for kids to pass. "The expectations are far too low for what students need," points out Ted Sanders, president of the Education Commission of the States. According to international test results released in mid-December, U.S. students continue to lag far behind those in many other countries, especially in math.

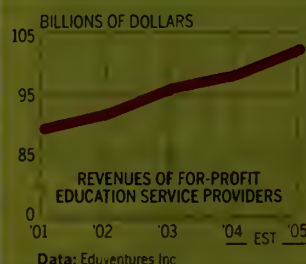
Money is another challenge. Although federal K-12 spending surged by more than a third during Bush's first term, the federal deficit will prevent any substantial increases in 2005. It is, that federal money upped national K-12 spending by less than 2%. The real burden to improve the schools will fall on state and local governments that already provide more than 90% of the money and face their own growing budget pressures.

Higher education—today's ticket to the middle class—is caught in a financial squeeze. Hard-pressed states are increasingly limiting aid to public colleges, passing the buck to students who have to make up the difference. As a result, public college tuition rose 10% last year, after a 14% increase in 2003. "But there has been no upward adjustment in the federal aid program in three years," says Amy Kohn, director of the Council on Education president David Ward. Congress will reauthorize the Higher Education Act, which authorizes financial aid, this year. But, predicts Ward, "there will be no new money."

That has led to a more stratified system. Less than one-third of well-qualified low-income students earn a BA within six years, vs. nearly two-thirds of higher-income students. And because a growing percentage of America's high school graduates are low-income or minority, the percentage of young adults going to college has leveled off in the U.S., even as it's rising in other countries. "We're on a collision course that could lead to a decline in U.S. competitiveness," warns Patrick Callan, president of the National Center for Public Policy & Higher Education.

Reversing course will require much bolder action. First, the U.S. must find the money to ensure that low-income students get an adequate education and a real opportunity to attend college. But money alone won't be enough. "The only way we will get there is by also adopting fundamentally different approaches" to education, argues Sanders. That means paying teachers for performance, as the Teaching Commission headed by IBM Chairman Louis V. Gerstner Jr. advocates. It also means making far better use of technology in schools, recruiting more math and science teachers, and insisting that colleges improve graduation rates. None of this will be easy. But a failure would be far more painful. ■

SPOTLIGHT



2005 PROSPECTS

B

Output Growth
4.0%

Growth Trend*

Output

\$8

Employment

2,827

* Avg. yearly change, 1990-2004

Data: Economy.com, page 10 Grade: C-

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FINANCE

BANKING

Bracing for the Squeeze

Earnings growth from financial services is set to slow as interest rates escalate. With companies lean from cost-cutting, mergers could provide the next profit surge.

FOR MANY FINANCIAL-service firms, an era of easy profits ended a few years back when the stock market bubble popped. Their salvation was the Federal Reserve's decision to slash interest rates to lowest levels in decades. For banks, a plunge in rates triggered an unexpected boom in mortgages and refinancings as many institutions rode to record profit. And on Wall Street, the rate cuts helped investment firms to generate high profits from bond trading that offset partially a decline in underwriting and stock-related activity. But what the Fed giveth, the market taketh away. Now the financial services industry finds itself struggling to adapt to rising rates. The trend will carry through 2005, given that the Fed is expected to push rates up by another full percentage point in the coming year. Bank profits are already being squeezed by rising lending spreads, as well

as the 26% plunge in mortgage activity over the past year. Lenders will be squeezed further in the new year, given the Mortgage Bankers Assn.'s prediction that mortgage lending will drop by another 18%, to \$2.3 trillion. And while banks have been able to off-

set those declines because of the brisk growth in home-equity lending, analysts are nonetheless bracing for a sharp slowdown from the 15% profit growth banks recorded last year. Andrew B. Collins, banking analyst for Piper Jaffray & Co., expects overall bank profits to expand 10.5% in 2005. Other Wall Street pros believe it may turn out to be even less than that. "The profit outlook for banks is not as bright as some might think," says Thomas K. Brown, chief executive of Second Curve Capital, a New York hedge fund specializing in bank stocks.

The rise in rates is also being felt on Wall Street, where profits were already down a collective 19% in 2004, according to Securities Industry Assn. (SIA) estimates. With merger activity and stock underwriting still well off the levels of the late 1990s, many investment banks have

year. The decline in such trading would be much worse, except that analysts believe the major Wall Street banks will be able to offset the expected declines in bond activity with a pickup in commodities trading. For example, continued volatility in oil, gas, minerals, and other raw materials will lead to greater demand for hedging strategies from big commodities buyers.

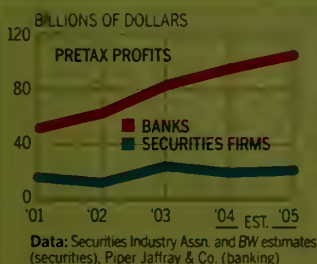
A DIP IN IPOs?

WITH THE TRADING picture mixed, Wall Street firms are depending on a rebound in their mainstay investment banking activities. On the underwriting front, the business of taking stocks public will be muted. While Wall Street underwrote \$64 billion in new domestic stock issues during 2004, Hintz believes that underwritings of initial public offerings could dip to \$60.5 billion in 2005.

The reason? Sarbanes-Oxley rules, which require that top executives of public companies certify the accuracy of their financial statements, are discouraging many development-stage companies from listing. Wall Street bankers—more mindful, following New York Attorney General Eliot Spitzer's probes, of their own liability in underwriting dubious IPOs—are exercising far more discretion as to

which companies they take public. On the mergers-and-acquisitions front, though, there's reason for hope of a further rebound. Economic growth is expected to throttle back in 2005, and companies have already slashed their cost structures to the bone. Many investment bankers believe

SPOTLIGHT



2005 PROSPECTS

C

2005
Growth
5.8%

Growth Trend*	7.0%
Output	\$856 bil.
Employment	3,743,000

*Avg. yearly change, 1990-2004
Data: Economy.com (see page 9) Grade: BusinessWeek

been able to stay in the black thanks to hefty gains in their proprietary trading in bonds. But with rates on the rise, Brad Hintz, an analyst for Sanford C. Bernstein & Co., predicts that the profits earned from proprietary trading by the major Wall Street firms will dip by 12% in the new

that Corporate America will come to view mergers as one of the best ways to drive profit growth over the next couple of years. Already, Wall Street is taking heart from the relatively warm reception that investors gave to Johnson & Johnson, for its \$25 billion deal to buy device maker Guidant Corp., and to Sprint Corp., following its \$35-billion merger with Nextel Communications Inc. "Clearly, the markets are receptive to M&A transactions," says David Goldfarb, chief administrative officer at Lehman Brothers Inc.

As a result, the value of announced deals, which in 2004 rebounded 40%, to \$741 billion, could surpass \$1 trillion in 2005, believes Frank Fernandez, chief economist for the SIA. Given the improving M&A outlook, Hintz believes that Wall Street profits could rise 8% to 9% in the new year. "2005 is going to be a somewhat better year," he says, "but not the gangbuster year that everyone had hoped for."

For the banking industry, the key to 2005 will be whether it can stoke demand for new lending. So far, companies have been reluctant to borrow, and with plenty of cash on hand—the S&P 500 companies alone are sitting on a stash of more than \$590 billion—they haven't had to. That's why Collins expects commercial lending will rise by a modest 3% to 5% in 2005. And any lending that does occur will become increasingly competitive. "Pricing has been cutthroat," notes Fari Kahn, a vice-president at Loan Pricing Corp., a New York research firm.

So, banks are likely to keep the credit spigot wide open to consumers, and this could cause trouble as interest rates rise. Analysts are warning that rising rates could increase defaults among mom and pop borrowers, who have taken on massive levels of debt during the long housing boom. Still, bankers remain sanguine that their consumer portfolios will be sound as long as the economy remains strong and

job numbers don't head south. "The consumer is doing just fine," Richard Kovacevich, CEO of Wells Fargo & Co. recently told analysts. "There won't be serious credit quality issues unless unemployment gets well over 6%."

With bank profits expected to slow as the mortgage boom fizzling, the banking industry could see a mini-wave of consolidation in 2005. There won't be as many megadeals as in the last period, but analysts expect the big players to go on the hunt for smaller regional banks to hold in their maps. "Acquirers aren't as aggressive in growing earnings the old-fashioned way because loan demand just isn't there," says Nick Studer, head of consultant Morgan Stanley's corporate and institutional banking practice. "So how do you grow earnings? You start merging." That's a simple reality in an era of rising rates.

—By Dean Foust in Atlanta

Emily Thornton

Mara Der Hovanesian in New York

CONSUMER DEBT

The Deeper the Hole, The Better for Business

When is bad debt good business? A small cadre of public collection agencies that specialize in the purchase of unpaid credit-card obligations and other bills is expected to get a lift next year as the so-far resilient consumer starts to show some signs of overload.

Consumers have borrowed a bundle in recent years—to the tune of over \$2 trillion in credit card and auto debt, according to the Federal Reserve. Add mortgages and the figure jumps to nearly \$10 trillion. All in all, the average U.S. household is deeper in the hole than it was four years ago, carrying debt of about \$9,200, up from \$7,200.

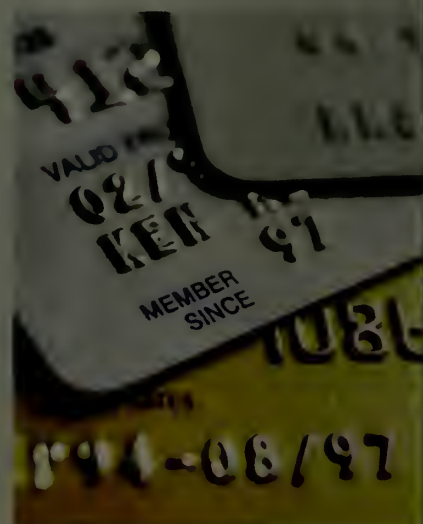
Since household income isn't keeping pace with debt growth, more consumers are getting close to the edge. Credit card charge-offs, or the bad debt that banks and others write off the books, were expected to hit a record \$65 billion in 2004, up from \$57.3 billion in 2003, according to the *Nilson Report*, a consumer credit newsletter. Nilson

forecasts the market for such debts will increase to \$2.8 trillion by 2010.

Who makes money on these bad debts? If they aren't trying to collect on the loans internally or through a third-party collection agency, lenders—banks, credit unions, auto finance companies, and retailers—sell these bad loans in bundles to specialty companies, such as Englewood Cliffs (N.J.)-based Asta Funding Inc., NCO Group in Horsham, Pa., Portfolio Recovery Associates of Norfolk, Va., and San Diego's Encore Capital Group. The loans are typically sold at 3¢ to 5¢ on the dollar.

Collection agencies will benefit as higher rates squeeze debtors

The more bad debt on the market, the less expensive the portfolios are. "Right now the banks are doing well, and delinquencies are low, so the market, and pricing, are a little tight," explains Andrew Zaro, CEO of Cavalry Investments LLC. It bought \$1.7 billion worth of receivables through Sept. 30, a 55% increase from the third quarter of 2003, and a boost of its total portfolio to \$13 billion. But with interest rates on the rise, the dollar sliding, and inflation looming, execs such as Zaro are betting the tides will soon turn.



"Eventually...some of the debtors will have trouble meeting their obligations," he says.

Even so, consumers need not be in dire straits for these businesses to boom. Portfolio Recovery Associates went public last at \$13, for instance, and hit \$35 by year-end. Asta Funding had a record \$22 million profit for the year ended Sept. 30, a 92% jump. Gary Stern, Asta's CEO, expects to exceed \$2.8 billion in purchases it made last year. "We're looking for more to buy," he says.

Ultimately, collection companies make their money from bad-debt portfolios by working out reasonable solutions with borrowers. The old days of terrorizing customers with threats is self-defeating, says Cavalry's Zaro: "If you don't help them, you don't help yourself."

—By Mara Der Hovanesian

HSM

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Now Come the Real Storms

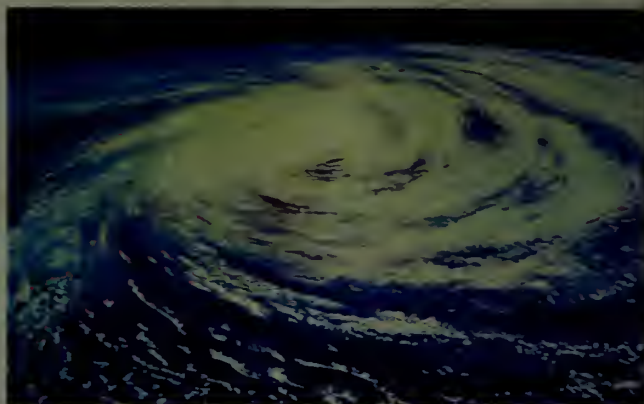
The specter of price wars and increased regulation could send industry executives running for cover **>> BY DIANE BRADY**

HOWLING WINDS. Baying lawyers. What could be worse? After four hurricanes and major industry scandals, you'd think U.S. insurers would want to forget 2004 quickly. Yet, according to the Insurance Information Institute (III), the industry generated its first underwriting profit since 1978 and its best return on equity since 1997.

Conditions in the New Year, however, may dampen industry spirits. For one thing, insurers have a tendency to initiate price wars as soon as money starts flowing. Already they are putting through slimmer premium increases—in the 3%-to-4% range, and tripping over one another in pursuit of new business as the economy picks up. At the same time, New York State Attorney General Eliot Spitzer's investigation into industry practices—including how brokers are compensated—will increase the industry's transparency, making it tougher to squeeze clients.

For now, insurers are feeling flush. Even after four hurricanes that racked up insured losses of \$20.5 billion last year, the industry enjoyed strong revenue from premiums, smart underwriting, and a 3.9% increase in investment income through the first nine months of the year. The industry's ratio of losses and expenses to premiums, known as the combined ratio, was expected to close out 2004 at less than 100, according to III, marking the first underwriting profit in a generation. Total property/casualty premiums are estimated at \$435.2 billion for 2004 and could rise about 3.4%, to \$450 billion, this year.

In coming months, disciplined underwriting will remain critical. With interest rates rising, there's no guarantee of double-digit stock market returns to offset payouts. A.M. Best Co. analyst Matt Mosher notes that premium revenues are softening to the point that they are not keeping pace with loss costs.

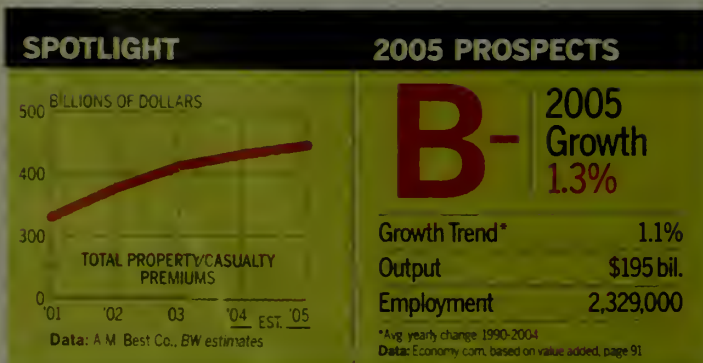


As for Spitzer's probe this past fall, the industry may be underestimating the importance of his action and the investigations by state regulators that followed. Robert A. Rusbuld of the Independent Insurance Agents & Brokers of America Assn., expresses a widely held view when he says investigating into "a few bad actors" could end up tarring an entire industry. Those bad actors happen to hail from some of the big names in the business—such as American International Group and Marsh & McLennan Cos.—and Spitzer has subpoenaed players in almost every area of insurance.

The issue isn't bid-rigging as much as the use of a widely, fundamentally flawed business model that creates conflict of interest. Brokers are supposed to work in their clients' best interest, yet they take vast fees from insurers for delivering business—often without disclosing those fees to customers. Practice must change. Bad publicity has already forced insurers to scrap contingency commissions.

Health insurers have also come under scrutiny from regulators, mostly over compensation practices. Still, 2005 could be a fine year, especially if they get some relief on rising drug prices. More important, there's hope that the Bush Administration may finally enact tort reform to reduce the damage of escalating lawsuits. Any caps would help increase predictability, which is critical in an industry where losses are never known at the time companies set prices on coverage. Notes Aetna Inc. CEO W. Rowe: "The total number of suits may not be that great, but the defensive medicine that the threat of suits induces—extra medical tests and things like that—adds up."

Right now, the insurance industry is in a spending spree. Datamonitor PLC predicts that North American insurers will pay out \$30.7 billion for technology in 2005, an increase of \$1.18 billion over 2004. That will be a boon if it helps obliterate outdated legacy systems and the labor-intensive manual processes that have long burdened the insurance industry with price-conscious consumers and more vigilant government regulators, insurers may find that the halcyon days have been blown clean away. ■



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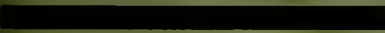
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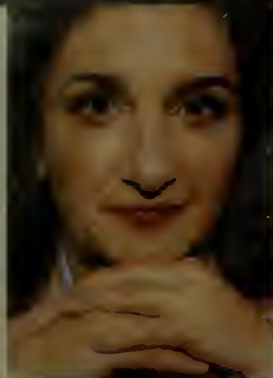
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BY MARA DER HOVANESIAN

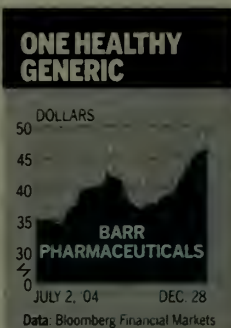
BIG PHARMA'S LOSS FROM EXPIRING PATENTS IS BARR'S GAIN.

AFFILIATED MANAGERS GROUP FUNDS JUST KEEP CLIMBING.

COGNOS IS ON THE FAST-GROWTH TRACK FOR SOFTWARE PROF

Barr: A No-Name Star

THE \$500 BILLION pharmaceutical industry is taking its knocks. Concerns over marketing tactics, drugs' efficacy, and safety are weighing on large caps such as Pfizer and Merck, which fell 30% in 2004 and pulled the Amex Pharmaceutical Index down by 8%. The outlook for generic producers, which live off the misery of big developers by capitalizing on brand-name patents that expire, looks far brighter, says Nick Colas of New York's Rochdale Securities. More than \$30 billion in patents will elapse by the end of 2007, which spells new potential for generics, of which Barr Pharmaceuticals (BRL) is Colas' favorite. Some 70 generic products make up three-quarters of Barr's \$1.24 billion in annual sales. The Woodcliff Lake (N.J.) company is also the biggest producer of birth-control drugs, with more than a third of the U.S. market. With Barr's solid pipeline, the stock, at 46, is a bargain, he says. (It trades at a p-e of 19 times 2005 earnings.) "The market is assigning no value to future growth," says Colas, whose six-month price target is 54. Barr has \$448 million in cash and a debt-to-capital ratio of less than 3%. Based on the company's guidance, Wall Street expects Barr to expand earnings by 8% to 13% in its fiscal year ending June, 2005, and 18% in 2006. Adam Greene of First Albany rates the stock a "strong buy." On Dec. 21, he raised his 2005 earnings estimate from \$2.37 a share to \$2.40.



How AMG Is Growing Like Gangbusters

WITH THE MUTUAL-FUND scandal ebbing and a record \$330 billion in new cash plowed into stock and balanced funds during 2004 (according to early estimates from fund tracker Strategic Insights), shares of public money managers have surged. Prides Crossing (Mass.)-based Affiliated Managers Group (AMG) rose 42%. Now at 67, the stock has legs, says Robert Lee of Keefe, Bruyette & Woods, a New York boutique investment bank specializing in financial services. AMG runs \$110 billion in assets through its majority stake in 30 boutique money-management shops. "Acquisitions are a key component to AMG's earnings growth," says Lee. Three deals in 2004 worth about \$350 million are yet to affect

AMG's earnings and stock price fully, he notes: emerging-market specialist Genesis Investment Management, growth shop TimesSquare Capital Management, and a first-ever hedge-fund firm, AQR Capital Management. Lee has upped his 2005 earnings forecast from \$4 to \$4.65 a share. Prudential Equity Group's John A. Hall has a 12-month target of 72. He figures every \$100 million AMG invests in new firms adds 15¢ to 20¢ per share in annual cash earnings, and he recently upgraded it to "overweight

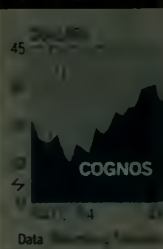
NO FUND MESS HERE



Cognos: Business Intelligence Never Looked So Smart

CANADA'S LARGEST software company, Cognos, is set to gain from the tech craze *du jour*: business intelligence (BI) software, say some savvy analysts. BI's Web-based software mines data among disparate systems to track such things as inventory and sales, then spits out full reports for managers to assess their businesses. Earnings rose 42% to record \$34.5 million, or 37¢ per diluted share, for Ottawa-based Cognos (COGN) in its fiscal 2005 third quarter, ended Nov. 30. The stock hit a 52-week high of 43.82 on Dec. 28, but it may go higher: Market researcher IDC says the \$7 billion BI software market will double by 2006 and that half of info tech budgets are already earmarked to pay for such integration systems. Robert Schwartz of Jefferies likes the stock and has a 12-month target of 51. Standard & Poor's specialty software analyst Zaineb Bokhari says Cognos, recently upgraded to a buy, has unique off-the-shelf products, some marketed by IBM via special contract. North America generates 60% of sales. Incoming CEO Rob Ashe, a 20-year Cognos veteran, intends to hire up to 150 each quarter to drive sales worldwide. ■

HOT SOFTWARE UP NORTH



Marcial is on vac

BusinessWeek online Gene Marcial's Inside Wall Street is posted at businessweek.com/today.htm at 5 p.m. EST on the magazine's publication day, usually Thursdays.

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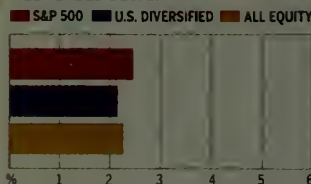
COMMENTARY

The markets were poised to end 2004 on a positive note as a week-long rally sent all three indexes to their highest levels in three years. Stronger-than-expected consumer-confidence numbers helped to bolster trading. Also, retailers began to report via trade groups that holiday sales were robust. As of Dec. 28, the S&P 500 was up 10.7% over 12 months.

Data: Bloomberg Financial Markets, Reuters

MUTUAL FUNDS

4-WEEK TOTAL RETURN



52-WEEK TOTAL RETURN



Data: Standard & Poor's

U.S. MARKETS

	DEC. 28	WEEK	% CHANGE YEAR TO DATE	LAST 12 MONTHS
S&P 500	1213.5	0.3	9.1	9.4
Dow Jones Industrials	10,854.5	0.4	3.8	3.9
NASDAQ Composite	2177.2	0.9	8.7	8.5
S&P MidCap 400	662.5	0.7	15.0	14.4
S&P SmallCap 600	329.6	0.7	21.9	20.4
DJ Wilshire 5000	11,960.9	0.4	10.8	10.8

SECTORS

BusinessWeek 50*	705.1	0.2	13.3	14.8
BW Info Tech 100**	372.2	0.7	6.2	8.2
S&P/BARRA Growth	583.5	0.3	5.0	5.1
S&P/BARRA Value	625.7	0.4	13.4	13.7
S&P Energy	287.1	-0.4	28.1	28.5
S&P Financials	411.4	0.1	8.3	8.6
S&P REIT	144.2	-0.8	24.5	23.7
S&P Transportation	241.4	-0.5	19.6	18.8
S&P Utilities	142.0	-0.4	19.9	19.9
GSTI Internet	179.8	2.8	24.2	22.8
PSE Technology	778.0	0.7	11.6	11.2

*Mar. 19, 1999=1000 **Feb. 7, 2000=1000

GLOBAL MARKETS

	DEC. 28	WEEK	% CHANGE YEAR TO DATE
S&P Euro Plus (U.S. Dollar)	1394.4	2.0	18.3
London (FTSE 100)	4798.1	0.4	7.2
Paris (CAC 40)	3824.8	0.5	7.5
Frankfurt (DAX)	4261.8	0.5	7.5
Tokyo (NIKKEI 225)	11424.1	1.9	7.0
Hong Kong (Hang Seng)	14197.0	0.3	12.9
Toronto (S&P/TSX Composite)	9287.4	0.4	13.0
Mexico City (IPC)	12912.7	1.6	46.8

FUNDAMENTALS

	DEC. 27	WEEK AGO
S&P 500 Dividend Yield	1.94%	1.91%
S&P 500 P/E Ratio (Trailing 12 mos.)	20.3	20.4
S&P 500 P/E Ratio (Next 12 mos.)*	16.9	16.9
First Call Earnings Revision*	0.10%	-0.03%

TECHNICAL INDICATORS

	DEC. 27	WEEK AGO
S&P 500 200-day average	11271	1125.8
Stocks above 200-day average	79.0%	79.0%
Options: Put/call ratio	0.65	0.58
Insiders: Vickers NYSE Sell/buy ratio	NA	6.75

BEST-PERFORMING GROUPS

	LAST MONTH %	LAST 12 MONTHS %
Home Entertainment	31.6	Fertilizers & Ag. Chems. 99.6
Fertilizers & Ag. Chems.	23.0	Internet Retail 83.1
Tires & Rubber	14.3	Internet Software 71.2
Employment Services	13.5	Steel 64.3
Insurance Brokers	12.8	Wireless Services 64.2

WORST-PERFORMING GROUPS

	LAST MONTH %	LAST 12 MONTHS %
IT Consulting	-14.1	IT Consulting
Gold Mining	-8.8	Semiconductor Equip.
Aluminum	-8.5	Insurance Brokers
Oil & Gas Exploration	-6.8	Semiconductors
Home Furnishings	-5.8	Electric Mfg. Svcs.

EQUITY FUND CATEGORIES

4-WEEK TOTAL RETURN	%	52-WEEK TOTAL RETURN	%
LEADERS		LEADERS	
Latin America	8.4	Latin America	37.5
Health	5.2	Real Estate	30.2
Real Estate	4.6	Natural Resources	28.1
Europe	4.0	Europe	24.3
LAGGARDS		LAGGARDS	
Precious Metals	-7.9	Precious Metals	-7.2
Natural Resources	-3.0	Technology	2.3
Pacific/Asia ex-Japan	1.3	Large-cap Growth	6.8
Utilities	1.3	Domestic Hybrid	7.5

EQUITY FUNDS

4-WEEK TOTAL RETURN	%	52-WEEK TOTAL RETURN	%
LEADERS		LEADERS	
Perkins Opportunity	11.8	iShares MSCI Austria Idx.	72.1
Alpine US RI. Est. Eq. Y	11.3	Bruce	54.5
CGM Realty	10.7	Morg. Stan. Inst. Eur. R. E.	49.0
Eaton Vance Grtr. India A	9.3	iShares MSCI Mex. Idx.	48.8
LAGGARDS		LAGGARDS	
Oppenheimer Real Asst. A	-13.2	ProFds. Smicdr. Ultsr. Inv.	-36.7
PFds. Pr. Mtls. Utr. Inv.	-13.0	Ameritor Investment	-35.3
Rydex Pr. Mtls.	-9.8	Thurlo Growth	-34.1
Am. Cent. Gl. Gold Inv.	-9.6	Rydex Electronics Inv.	-23.3

INTEREST RATES

KEY RATES	DEC. 28	WEEK AGO
Money Market Funds	1.71%	1.71%
90-day Treasury Bills	2.26	2.19
2-Year Treasury Notes	3.07	3.07
10-Year Treasury Notes	4.29	4.20
30-Year Treasury Bonds	4.92	4.83
30-Year Fixed Mortgage†	5.69	5.68

†BancX

BLOOMBERG MUNI YIELD EQUIVALENTS

Taxable equivalent yields on AAA-rated, tax-exempt municipal bonds, assuming a 30% federal tax rate.

	10-YR BOND	30
General Obligations	3.60%	
Taxable Equivalent	5.20	
Insured Revenue Bonds	3.8	
Taxable Equivalent	5.44	

THE WEEK AHEAD

PURCHASING MANAGERS' INDEX

Monday, Jan. 3, 10 a.m. EST

» The December factory activity index from the Institute for Supply Management probably crept up to 58%, from 57.8% in November. That's according to the median forecast of economists surveyed by Action Economics LLC.

CONSTRUCTION SPENDING

Monday, Jan. 3, 10 a.m. EST

» Building outlays in November are expected to have increased by

0.5%, after holding steady during October.

VEHICLE SALES Tuesday, Jan. 4

» Sales of U.S. and imported vehicles most likely rebounded to an annual rate of 17 million in December. November sales came in at a pace of 16.4 million vehicles, the slowest rate since June.

FACTORY INVENTORIES Tuesday, Jan. 4, 10 a.m. EST

» Manufacturing inventories probably increased 0.3% in

November. In October, inventories grew by 0.5%

EMPLOYMENT Friday, Jan. 7, 8:30 a.m. EST

» December nonfarm payrolls probably grew by 180,000 jobs, after a November gain of 112,000. Factory payrolls are forecast to have added 3,000 positions, after three months of declines. The unemployment rate most likely held steady at 5.4%, while average hourly earnings probably improved by 0.3%.

The BusinessWeek production index moved up to 234.5 for the week ended Jan. 18, an increase of 0.4% from a year ago. Before calculating the four-week moving average, the index fell to 235.6.

BusinessWeek on

For the BW50, more investor data, and the components of the production index visit www.businessweek.com/magazine/

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Here Comes the Year of the Deal

AFTER YEARS OF stagnation, the U.S. mergers-and-acquisitions market is heating up again. The value of deals in the fourth quarter totaled some \$250 billion, including Kmart Holding Corp.'s agreement to buy Sears, Roebuck & Co. for \$11 billion, the announced \$39 billion deal between Sprint and Nextel, and Exelon's \$12 billion bid for utility Public Service Enterprise Group (page 32).

All of the factors are in place to make 2005 the year of the big deal. The economic recovery is on a firm footing, enabling executives to take bigger risks. U.S. corporations have more than \$2 trillion in cash and short-term assets on hand, enough to pay for plenty of acquisitions. Potential foreign buyers have the advantage of the weak dollar. The increased globalization of business makes economies of scale more important than ever. And the announcement of a few big deals is quickening the pulse of corporate managers, who are scouting for potential merger partners or acquisition targets, lest they be left behind.

Corporate deals are essential to the workings of the U.S. economy. They wipe out excess or obsolete capacity, allow companies to adjust to changing market realities, and even

help balance out the trade deficit, as foreign companies U.S. outfits. The willingness to do big deals and reposit corporate assets reflects the flexibility of the U.S. economy. One key reason why the U.S. was able to adapt so quickly to the Information Revolution of the 1990s.

However, fallout from a new M&A boom could turn out

But the new M&A boom could have unwanted effects. Bush & Co. beware

be a major unanticipated problem in 2005. Rapid consolidation could increase pricing power in many industries. For example, a series of big telecommunications mergers could reduce competition and boost inflation in that sector. Some critics have suggested that the oil company mergers of the 1990s were one reason why gasoline prices have risen so sharply in recent years. Moreover, a string of foreign purchases of major U.S. companies could

stir up politics, renewing fears about the "selling of America."

The downside of consolidation was less apparent during the M&A boom of the 1990s, since acquisitions and consolidations were balanced out by an equal amount of business formation and initial public offerings. New, homegrown companies such as Yahoo! Inc. and eBay Inc. became formidable competitors to existing businesses. At the time, however, there's no sign of a similar surge of start-ups leavening the economy.

By natural inclination, President George W. Bush and his economic advisers lean away from government intervention in the workings of the market. Still, it's the right time for the government's trustbusters to stay alert.

Managers Who Hit Their Marks

GOOD MANAGEMENT is never one-size-fits-all. That's why *BusinessWeek's* list of the best managers of the year reflects a variety of skills and strategies that enabled some companies to prosper in 2004 while others sank (page 55).

Winning in some cases was simply a matter of good execution. Robert L. Nardelli, chief executive of Home Depot Inc., boosted efficiency at the No. 2 U.S. retailer and invested in new technology. The result: profit margins above 30%. Henning Kagermann steered German software giant SAP through the tricky waters of the tech marketplace. His focus on holding down costs is one reason why profits are expected to rise by 20% in 2004 over the previous year. And Anne M. Mulcahy of Xerox Corp. and Edward D. Breen Jr. of

Tyco International Ltd. turned around struggling companies.

Other CEOs did well by listening to customers. Joseph Tucci of EMC Corp. revamped the data-storage giant's product line to reflect desires for less expensive options. The reward: a 34% hike in revenues in the first nine months of 2004. Hyundai Motor Co. CEO Chung Mong Koo, son of the founder, helped boost quality and customer satisfaction. Jeffrey R. Immelt turned General Electric Co. into a more nimble, customer-driven company focused on innovation.

One key skill a CEO can supply is the ability to size up the next generation of executives. Such nurturing of leadership made PepsiCo CEO Steven S. Reinemund a standout and enabled Pepsi to tap into new markets. And Philip H. K. chairman of Nike Inc., took the bold step of hiring an outsider, William Perez, to succeed him as CEO.

Sometimes the best managers are not found in blue-boardrooms. John W. Henry, the principal owner of the Boston Red Sox, broke an 86-year championship drought by boosting revenues and emphasizing a quantitative approach to judging players. And Karl Rove was the architect of President George W. Bush's successful reelection campaign, perhaps the biggest management triumph of the year.

There will no doubt be new challenges in 2005. But the lessons offered by these top managers are suited even to tomorrow's business conditions.

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January 17



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TONY BIANCO (P.64)



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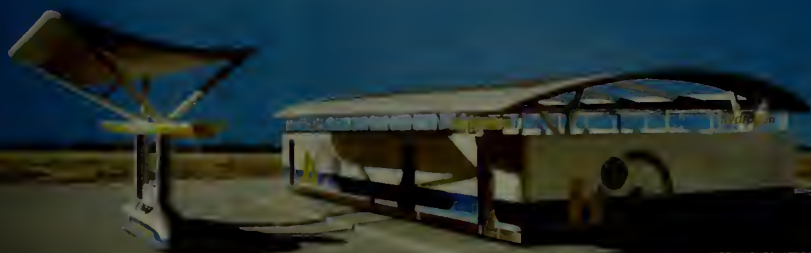


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Is there a business model that will allow New York Times Co. to grow and still deliver quality journalism?



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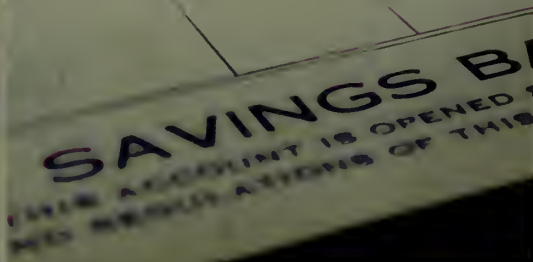
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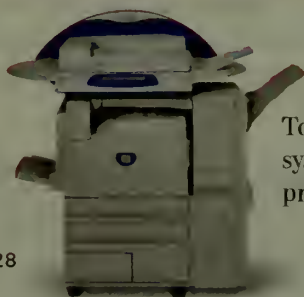
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JP Front

"It's geographically confusing and absurd."

—John Nicoletti, spokesman for Anaheim, Calif., which will sue to stop its Major League Baseball team from changing its name to "the Los Angeles Angels of Anaheim"

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he do for an encore? In
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is an old hand at wring-
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hen, of course, there's
which is 44% of Mitsui's
ness and has nearly
oled in price in 12
ths. Especially in de-
d is coke, a coal product
to make steel. Ross's
national Coal Group is the

fifth-largest U.S. coal produc-
er. He figures that coal prices
will stay strong this year.
"Most of the developing
world is very short of coal,"
he notes.

In addition to Ross, press
reports in Japan indicate that
trading house **Sumitomo** and
a consortium including
Nippon Steel may make bids.
Neither the IRCJ nor these
companies would comment.

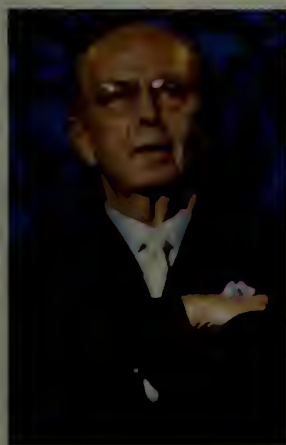
If Ross losses out in Japan,
he still has China. On Dec. 10,
International Textile Group,
comprising **Burlington**

Industries and
Cone Mills—
which Ross
brought out of
bankruptcy—
announced a
joint venture in
China to make
and distribute
sheets and other
home textiles.
Ross's partner,
China Ting Group,
will sell the
goods in 25
stores under the
Burlington
name.

On Jan. 1, U.S.
textile trade quo-

tas expired, leaving Ross with
assets that could get swamped
by the Chinese. Ross says his
U.S. plants are still profitable,
and "we have no present
plans to close any of them."
But in light of his earlier ef-
forts to keep tariffs on Chinese
imports, is the new venture a
contradiction? "We don't get
to make our government's
policy," he says.

—Chester Dawson and Olga
Kharif, with Nanette Byrnes



THREAD COUNTER

Ross is now focused on
Asian coal and textiles



INTO THE BOX

Bear Stearns Wraps Up a Deal

THE PRIVATE EQUITY group at investment giant **Bear Stearns**
wants to build a major packaging company, and it has the first
of its pieces. Bear Stearns has snapped up **The John Henry Co.**, a
93-year-old Lansing (Mich.) outfit, *BusinessWeek* has learned.
The value of the deal wasn't disclosed, but it's estimated to be
in excess of \$100 million.

Bear Stearns plans to use John Henry as a base to which
more acquisitions can be bolted. Then it plans to sell off the
business or take it public. John Henry, which already has \$150
million in revenue and 1,000 employees, makes and prints
packaging for over-the-counter drugs, medical devices,
horticultural products, and note cards for floral arrangements.

May sound boring, but who says that's bad? "One of the
things we like about the packaging industry is its stability," Bear
Stearns Merchant Banking Managing Director Phil Carpenter
says. It has steady growth, not subject to the abrupt swings of
more volatile businesses. Carpenter sees other packaging seg-
ments ripe for the plucking—media, for one. Whether or not
media companies make money on CDs and DVDs, they need
some sort of package for their product.

—Steve Rosenbush

THE TSUNAMI 'IT REMINDED ME OF NIAGARA'

DIPAK JAIN, dean of Northwestern University's Kellogg School of Management, took his family to Phuket for a break from his annual winter teach-



JAIN Medical care has to improve

ing stint in Bangkok. Like many, they got caught up in the tsunami. Luckily, a

wide lagoon near their hotel soaked up most of the waves. After he and his family returned to Bangkok, Jain spoke by phone to B-Schools Editor Jennifer Merritt.

What was the impact like?

I saw huge waves of water coming toward us. It reminded me of Niagara Falls. The waves were carrying fishing boats and lounge chairs from the beach and garbage.

How much damage will be done to the local economies?

This is going to affect [Thailand's] gross domestic product by 0.3%. That is significant. Next year, people will not be planning for trips in this region. Many of the [affected] areas thrive on tourists, so the tourists have to feel safe. If they don't feel safe, it is going to affect the economy in a worse way.

What should countries in the West and Asia do to help?

The region needs to improve geological- and weather- prediction systems—not just the technology but talent. Companies or governments should [train] people from the region.

How else can developed nations help?

In the U.S., you may go to a small hospital, but if it cannot help you, it will be associated with a larger research hospital. This type of system does not exist [in developing nations]. Look at Sri Lanka: They didn't have enough helicopters to airlift people who needed medical care, and they had no support hospitals

in bigger cities. Companies [can help] develop a system [to link hospitals] in case there is a problem.

BusinessWeek online For more, go to www.businessweek.com

COWBOY EFFECT BRANDING

It seems overseas consumers do not regard all U.S. brands equally. In a survey by Global Market Insite, American Express, AOL, Starbucks, American Airlines, Marlboro, and McDonald's are seen as arrogant and "very American." But Visa, Calvin Klein, Kleenex, and Kodak are viewed as trustworthy and likeable. According to Insite, 50% of overseas consumers distrust U.S. companies, and 68% say they formed a negative view due to the Iraq war. Brands "America" in their names are targets for scorn, while others are seen as exporting the worst of the U.S.—a fast-food culture—franchise by franchise.

—David I.

Marlbo



DRAWN & QUARTERED

The New Economy

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HOT DATES

MILESTONES ON THE ROAD TO 2006

THE YEAR AHEAD will bring plenty of important events in the business, political, and cultural realms, not to mention court dates aplenty—for Bernie Ebbers, Dennis Kozlowski, and various Enron execs, among others. Here are some dates on our calendar for 2005:



FEBRUARY 2005

10

The **DEMOCRATIC NATIONAL COMMITTEE** meets to elect a chair and other party leadership posts. Who will lead the Dems out of the wilderness?

FEBRUARY 2005



The **KYOTO PROTOCOL** environmental accord takes effect for participating nations. The U.S. isn't among them, but most big trade partners are.

FEBRUARY 2005

28

MUTUAL FUND MANAGERS are required to provide details on how salaries and bonuses are figured, as well as potential conflicts of interest.

MARCH 2005



MARTHA STEWART is released from prison. Can she readjust to life on the outside quickly enough to boost her company's fortunes?

APRIL 2005

1

Five executives from Enron Broadband go to trial; concrete expected to arrive for the **FREEDOM TOWER** at the World Trade Center site within days.

JUNE 2005

15

After today, all public company financial statements must **EXPENSE STOCK OPTIONS**. That unless the tech lobby scuttles it.

JULY 2005

6

The host of the 2012 **OLYMPIC SUMMER GAMES** is announced. New York is on the shortlist for the bid, as are Paris, London, Moscow, and Madrid.

JULY 2005

17



DISNEYLAND celebrates its 50th anniversary. Another milestone for the Magic Kingdom: Hong Kong Disneyland opens Sept. 12.

OCTOBER 2005

26

To enter the U.S., travelers must present **PASSPORTS** containing chips that store their biometric identifiers.

Get into it.

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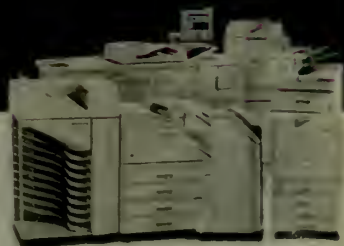
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Online Raises Its Sights

THIS MONTH WE MARK THE 10th anniversary of BusinessWeek Online. Over the years, we've enhanced the site so that it offers more than just the magazine, bringing you late-breaking business and investor news—along with tools for putting that news to work. We've also launched a host of features

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■ A redesigned Book Reviews page. Check out BusinessWeek book reviews, best-seller lists, and interviews with prominent authors, along with a way of accessing a broad range of executive summaries of business books through service from a partner, Soundview at businessweek.com/lifestyle/books.

We hope these additions will help you get even more out of BusinessWeek Online.

Kathy Rebello
 EDITOR-IN-CHIEF
 BUSINESSWEEK ONLINE



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COKE CAN ING BACK THE MAGIC

TIME AT Coca-Cola Co. began during
erto Goizueta's last years, outlived M.
glas Ivester's stint, and ended with
glas Daft's slice-and-dice job ("Coca-
: The real problem," Cover Story,
20). I remember the early feeling of
e within the company, how wonder-
felt to produce and market a product
l and adored worldwide. Unfortun-
y, Coke, by putting long-timers out to
re early, laying off thousands, and
ng others out, eliminated those who
how to make that magic sparkle, re-
ng the company to just another soft
c manufacturer fighting for share.
nce, I mentioned to a marketing exec
my friends wished Coke would air
nostalgic Mountain Top and Sprite
stmas ads—strong connections with
friends' childhood memories of warm
fuzzy holidays. "Can't do that," came
response. "It's off target." It was ob-
s to me even then that the company
lost sight of how special it was in con-
ers' minds, acting on marketing re-
ch numbers rather than on the de-
of its consumers' hearts and souls.

—John Huston
Marietta, Ga.

R STORY ON Coca-Cola made me
lexed. After reading and rereading it,
de up my mind that, too often, the fi-
ial community appraises companies
l on "emotional" factors. Coke's
ness performance is measured by
and growth figures, and the finan-
community blames Coke's sole em-
is on the carbonated drinks business.
my opinion, the "real" business fig-
n your table "Coke vs. Pepsi" tell an-
story: Coke with its \$4.3 billion in
ngs on \$21 billion in sales is still a
r-performing company than PepsiCo
making \$3.6 billion on \$27 billion in
. And I bet Warren E. Buffett thinks
oo.

—Ronald Appeltants
Hasselt, Belgium

IS OTHERWISE excellent discussion
e strategic difficulties facing Coca-
Dean Foust takes a cheap shot. He
ests that Coke's decision to spin off
U.S. bottling operations "in some
" prefigures Enron with its whimsi-
named special-purpose entities such
hewbacca. What exactly "in some
" means is left unexplained.
rmer Enronoids are looking at seri-
ail time for what went on at that
pany, and it cannot have escaped a

CORRECTIONS & CLARIFICATIONS

In "Squeeze your portfolio harder" (Smart Strategies, Dec. 27-Jan. 3), a Charles Schwab representative provided *BusinessWeek* with outdated pricing for options trades made by phone or online. Correct pricing for investors trading online and writing any number of contracts is a \$9.95 commission and \$1.40 fee for the first contract and \$1.40 for each additional one; trading by automated phone is \$29.95 for the first contract, plus the \$1.40 fee. Also, the accompanying table ("Getting a premium") on covered call options should have noted that dividend payments received over the life of the option are included in the quoted returns.

In "Hedge funds: Outfoxing the SEC" (News: Analysis & Commentary, Dec. 27-Jan. 3), Paul F. Royce, director of the SEC's division of investment management, told *BusinessWeek* the agency would rethink a new rule requiring fund advisers to register with the SEC "if we see a significant invasion of the rule." He meant to say: "evasion of the rule."

writer as skilled as Foust that he was indulging in a pernicious form of guilt by association. Pernicious, and, by the way, wholly unproven.

—John Endean
President
American Business Conference
Washington

READING THE FINE PRINT ON IBM'S CHINA DEAL

AS FOR IBM's decision to sell its PC business to Lenovo Group Ltd., IBM is disposing of a money-losing business ("China goes shopping," News: Analysis & Commentary, Dec. 20). For Michael S. Dell to be critical of this sale when his company's products are sourced by overseas suppliers is a little disingenuous. At least IBM has retained a minority interest in the new company. I don't believe other companies like Dell Inc. or Hewlett-Packard Co. can say that.

—John Ngai
Rego Park, N.Y.

I FIND CHINESE business efforts at branding rather ironic considering their government's blatant disregard for trademarks and intellectual-property rights. Perhaps the Chinese government will finally hear the cries for protection of these rights if they are from within.

—Peter C. Plaia
Jefferson, La.

THOUSANDS OF companies are trying to achieve the public recognition and brand loyalty that IBM has enjoyed from its PC and laptop business. After adding the value of its strategic advertising impact on customer and prospect awareness to its aftertax, bottom-line performance, the purchase of IBM's business appears to be a brilliant strategic move by Chinese-owned Lenovo and a blunder by IBM.

—William A. Pauwels Sr.
Franklin Lakes, N.J.

MERGERS AND THE DISAPPEARANCE OF SERVICE

IN "WHY CONSUMERS hate mergers" (The Corporation, Dec. 6), you note two seemingly contradictory survey results about BP PLC: Your finding is that customers feel they get 13% less value in terms of price and quality of service, whereas BP's study shows that customers are more satisfied with service than before. This discrepancy is attributable to two common factors: First, when companies lower their product or service quality, raise prices, curtail distribution, or cut advertising, customers tend to defect. The ones who remain generally have the most positive attitudes, so the new average ratings tend to rise.

Second, the meaning of service changes over time. Attendant service? Self-service? Repair and maintenance service? Car wash? Food shop? Ease of payment? Ambience? As fewer service stations have mechanics or technicians, as full-service and dealers have evolved toward obsolescence, as credit-card accepters are now nearly universal, as bank cards have replaced oil company credit cards, customers change their referents, with many finding the service concept irrelevant.

—Joseph M. Kamen
Flossmoor, Ill.

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The Gaijin Who Saved Nissan

SHIFT Inside Nissan's Historic Revival

By Carlos Ghosn and Philippe Riès; Currency/Doubleday; 232pp; \$25.95

It was a union born of desperation. Back in 1999, Nissan was in a death spiral. The company was carrying massive debts, heavy losses, and a badly damaged brand. Renault was a middling European auto maker with a far-from-inspiring future. So when Renault CEO Louis Schweitzer ponied up \$5 billion to buy

effective control of Nissan that year, there was skepticism, to say the least. Industry wags such as Robert Lutz, currently vice-chairman of General Motors Corp., publicly stated that Renault might as well have dumped the billions in the Pacific Ocean. Into the breach came Carlos Ghosn, a savage cost-cutter and first-class intellect. But even he gave this salvage job only a 50-50 chance.

Well, today, Nissan is back, no doubt about it. Under Ghosn, now CEO, the company has found its killer instinct. It's turning out great cars and achieving the highest profit margins in the business—even slightly ahead of Toyota Motor Corp. Just how Ghosn managed this is instructively chronicled in *Shift: Inside Nissan's Historic Revival*, jointly written by Ghosn and French journalist Philippe Riès. Mercifully short on managerial bromides, the compact book offers a trove of practical advice to executives who could find themselves in unfamiliar business cultures with different rules of engagement—and not much time to sort things out. On the negative side, the authors have little to say about current failings at Nissan, and Ghosn at times seems out of touch—witness his skepticism on the commercial viability of hybrid cars.

Ghosn's multicultural background made him unusually well-suited to take on the Nissan challenge. He was born in Brazil to Lebanese immigrants. As a child he moved to Lebanon and then on to France, where he earned engineering degrees from the prestigious Ecole Polytechnique and Ecole des Mines de Paris. Along the way he picked up five languages, a love of logic and numerical precision, and an ability to feel his way through unfamiliar cultural terrain. His first stop after graduate studies was Michelin. There, he quickly moved up the ranks—from plant manager to chief operating officer. And when Schweitzer needed to hire a No. 2 to shake Renault out of its stupor in the mid-1990s, Ghosn was an ideal choice. He soon caused an uproar by shuttering a Renault plant in Belgium and wringing out billions in costs by leaning on suppliers and in-house units alike.

Fixing Nissan, however, made that stuff look easy. Ghosn

determined that he had to slash purchasing costs by 20%, reduce capacity by 30%, close five plants, and displace 20,000 odd workers through layoffs and attrition. An American CEO could do much of that in months. Not so in Japan. In the late 1990s, its public viewed the sale of national champions to foreigners as something akin to treason. Nissan belonged to a massive *keiretsu*—a web of business alliances—in which stability trumped sound financial management. It had billions of yen tied up in cross-shareholdings with suppliers and *keiretsu* partners. When Ghosn announced plans to trim the number of Nissan's steel suppliers from five to three, Yoichi Shimoguchi, CEO of NKK Steel, protested that "Toyota will never act in such a way." (NKK, now part of JFE Steel Corp., survived the cut but saw its Nissan business slashed by half.)

Perhaps Ghosn's biggest test was overcoming the deep

denial inside Nissan about the company's perilous condition. In Japan, such large companies were viewed as simply too big to fail. If the *keiretsu*-linked banks didn't rush to the rescue, most execs figured, then the government would. In reality, though, a decade of economic stagnation had frayed such insider ties severely.

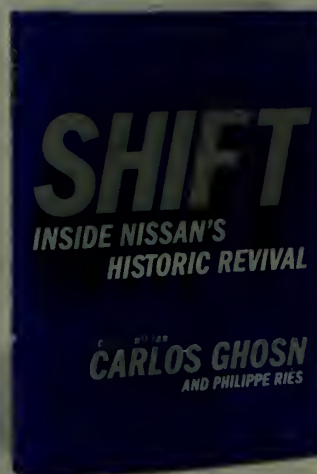
Ghosn first had to determine just how deep the financial rot ran. He then set up cross-functional teams of Renault and Nissan management teams in engineering, design, and sales. These were to uncover every problem and set new, realistic performance goals. And Ghosn made it clear he would tolerate no backsliding: "If you disagree with the plan," he writes, "you've got to leave the company."

As cost savings and debt reduction freed up cash, Ghosn took daring steps to rejuvenate the Nissan brand. He revived the Z-series sports-coupe line with the Nissan 350Z, a model discontinued in 1996. In the meantime, Nissan leaped into new markets with the Murano SUV and the Quest minivan. Nissan also prospered from high-profit size vehicles such as the Ti

truck, Armada SUV, and Infiniti QX56.

As Nissan took off, so did the cult of Ghosn inside Japan. Adulation aided the turnaround, but at the end of the day, admits, it will be the cars that matter. Ghosn also counts himself lucky for arriving in a Japan so fed up with its post-bubble malaise that it was open to change, even from a gaijin. But whether it was luck or talent, Ghosn's efforts have had a major impact in Japan that goes beyond Nissan. That is why *Shift* is worth reading—and Ghosn is worth watching in years ahead.

—By Brian Br



Under Ghosn, the auto maker found its killer instinct

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VIAGRA is prescribed to treat erectile dysfunction. We know that no medicine is for everyone. If you use nitrate drugs, often used for chest pain (known as angina), don't take VIAGRA. Taking these drugs together could cause your blood pressure to drop to an unsafe level.

The most common side effects of VIAGRA are headache, facial flushing, and upset stomach. Less common are bluish or blurred vision, or being sensitive to light. These may occur for a brief time. Remember to protect yourself and your partner from sexually transmitted diseases.

Talk with your doctor first. Make sure you are healthy enough to have sex. If you have chest pain, nausea, or other discomforts during sex, seek medical help right away. The same is true if you have an erection that lasts more than 4 hours. Call for help at once.

VIAGRA is covered under most Managed Care Plans.

For some men, in as quickly as 10 minutes; for most, in under a half hour (statistical significance at 14 minutes). In this study, VIAGRA responders, given 100 mg 2 hours after eating, were timed to see how fast they got an erection that enabled them to have sex. Data on file. Pfizer Inc., New York, NY

Please see our patient summary of information for VIAGRA (25 mg, 50 mg, 100 mg) tablets on the following page.

To learn more, visit viagra.com or call 1-888-4VIAGRA

VIAGRA
(sildenafil citrate) tablets

Not all medications are for everyone.
Pfizer reminds you
to consult with your physician.



U.S. Pharmaceuticals

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PATIENT SUMMARY OF
INFORMATION ABOUT

VIAGRA®

(sildenafil citrate) tablets

This summary contains important information about VIAGRA®. It is not meant to take the place of your doctor's instructions. Read this information carefully before you start taking VIAGRA. Ask your doctor or pharmacist if you do not understand any of this information or if you want to know more about VIAGRA.

This medicine can help many men when it is used as prescribed by their doctors. However, VIAGRA is not for everyone. It is intended for use only by men who have a condition called erectile dysfunction. **VIAGRA must never be used by men who are taking medicines that contain nitrates of any kind, at any time. This includes nitroglycerin. If you take VIAGRA with any nitrate medicine your blood pressure could suddenly drop to an unsafe or life threatening level.**

• What Is VIAGRA?

VIAGRA is a pill used to treat erectile dysfunction (impotence) in men. It can help many men who have erectile dysfunction get and keep an erection when they become sexually excited (stimulated).

You will not get an erection just by taking this medicine. VIAGRA helps a man with erectile dysfunction get an erection only when he is sexually excited.

• How Sex Affects the Body

When a man is sexually excited, the penis rapidly fills with more blood than usual. The penis then expands and hardens. This is called an erection. After the man is done having sex, this extra blood flows out of the penis back into the body. The erection goes away. If an erection lasts for a long time (more than 6 hours), it can permanently damage your penis. You should call a doctor immediately if you ever have a prolonged erection that lasts more than 4 hours.

Some conditions and medicines interfere with this natural erection process. The penis cannot fill with enough blood. The man cannot have an erection. This is called erectile dysfunction if it becomes a frequent problem.

During sex, your heart works harder. Therefore sexual activity may not be advisable for people who have heart problems. Before you start any treatment for erectile dysfunction, ask your doctor if your heart is healthy enough to handle the extra strain of having sex. If you have chest pains, dizziness or nausea during sex, stop having sex and immediately tell your doctor you have had this problem.

• How VIAGRA Works

VIAGRA enables many men with erectile dysfunction to respond to sexual stimulation. When a man is sexually excited, VIAGRA helps the penis fill with enough blood to cause an erection. After sex is over, the erection goes away.

• VIAGRA Is Not for Everyone

As noted above (*How Sex Affects the Body*), ask your doctor if your heart is healthy enough for sexual activity.

If you take any medicines that contain nitrates – either regularly or as needed – you should never take VIAGRA. If you take VIAGRA with any nitrate medicine or recreational drug containing nitrates, your blood pressure could suddenly drop to an unsafe level. You could get dizzy, faint, or even have a heart attack or stroke. Nitrates are found in many prescription medicines that are used to treat angina (chest pain due to heart disease) such as:

- nitroglycerin (sprays, ointments, skin patches or pastes, and tablets that are swallowed or dissolved in the mouth)
- isosorbide mononitrate and isosorbide dinitrate (tablets that are swallowed, chewed, or dissolved in the mouth)

Nitrates are also found in recreational drugs such as amyl nitrate or nitrite ("poppers"). If you are not sure if any of your medicines contain nitrates, or if you do not understand what nitrates are, ask your doctor or pharmacist.

VIAGRA is only for patients with erectile dysfunction. VIAGRA is not for newborns, children, or women. Do not let anyone else take your VIAGRA. VIAGRA must be used only under a doctor's supervision.

• What VIAGRA Does Not Do

- VIAGRA does not cure erectile dysfunction. It is a treatment for erectile dysfunction.
- VIAGRA does not protect you or your partner from getting sexually transmitted diseases, including HIV — the virus that causes AIDS.
- VIAGRA is not a hormone or an aphrodisiac.

• What To Tell Your Doctor Before You Begin VIAGRA

Only your doctor can decide if VIAGRA is right for you. VIAGRA can cause mild, temporary lowering of your blood pressure. You will need to have a thorough medical exam to diagnose your erectile dysfunction and to find out if you can safely take VIAGRA alone or with your other medicines. Your doctor should determine if your heart is healthy enough to handle the extra strain of having sex.

Be sure to tell your doctor if you:

- have ever had any heart problems (e.g., angina, chest pain, heart failure, irregular heart beats, heart attack or narrowing of the aortic valve)
- have ever had a stroke
- have low or high blood pressure
- have a rare inherited eye disease called retinitis pigmentosa
- have ever had any kidney problems
- have ever had any liver problems
- have ever had any blood problems, including sickle cell anemia or leukemia
- are allergic to sildenafil or any of the other ingredients of VIAGRA tablets
- have a deformed penis, Peyronie's disease, or ever had an erection that lasted more than 4 hours
- have stomach ulcers or any types of bleeding problems
- are taking any other medicines

• VIAGRA and Other Medicines

Some medicines can change the way VIAGRA works. Tell your doctor about **any medicines** you are taking. Do not start or stop taking any medicines before checking with your doctor or pharmacist. This includes prescription and nonprescription medicines or remedies:

- Remember, VIAGRA should never be used with medicines that contain nitrates (see *VIAGRA Is Not for Everyone*).
- If you are taking alpha-blocker therapy for the treatment of high blood pressure or prostate problems, you should not take a dose of greater than 25 mg of VIAGRA at the same time (within 4 hours) as you take your dose of alpha-blocker.
- If you are taking a protease inhibitor, your dose may be adjusted (please see *Finding the Right Dose for You*).
- VIAGRA should not be used with any other medical treatments that cause erections. These treatments include pills, medicines that are injected or inserted into the penis, implants or vacuum pumps.

• Finding the Right Dose for You

VIAGRA comes in different doses (25 mg, 50 mg and 100 mg). If you do not get the results you expect, talk with your doctor. You and your doctor can determine the dose that works best for you.

- Do not take more VIAGRA than your doctor prescribes.
- If you think you need a larger dose of VIAGRA, check with your doctor.
- VIAGRA should not be taken more than once a day.

If you are older than age 65, or have serious liver or kidney problems, your doctor may start you at the lowest dose (25 mg) of VIAGRA. If you are taking protease inhibitors, such as for the treatment of HIV, your doctor may recommend a 25 mg dose and may limit you to a maximum single dose of 25 mg of VIAGRA in a 48 hour period. If you are taking alpha-blocker therapy, you should not take a dose of greater than 25 mg of VIAGRA at the same time (within 4 hours) as your dose of alpha-blocker.

• How To Take VIAGRA

Take VIAGRA about one hour before you plan to have sex. Beginning in about 30 minutes and for up to 4 hours, VIAGRA can help you get an erection if you are sexually excited. If you take VIAGRA after a high-fat meal (such as a cheeseburger and french fries), the medicine may take a little longer to start working. VIAGRA can help you get an erection when you are sexually excited. You will not get an erection just by taking the pill.

• Possible Side Effects

Like all medicines, VIAGRA can cause some side effects. These effects are usually mild to moderate and usually don't last longer than a few hours. Some of these side effects are more likely to occur with higher doses. The most common side effects of VIAGRA are headache, flushing of the face, and upset stomach. Less common side effects that may occur are temporary changes in color vision (such as trouble telling the difference between blue and green objects or having a blue color tinge to them), eyes being more sensitive to light, or blurred vision.

In rare instances, men have reported an erection that lasts many hours. You should call a doctor immediately if you ever have an erection that lasts more than 4 hours. If not treated right away, permanent damage to your penis could occur (see *How Sex Affects the Body*).

Heart attack, stroke, irregular heart beats, and death have been reported rarely in men taking VIAGRA. Most, but not all, of these men had heart problems before taking this medicine. It is not possible to determine whether these events were directly related to VIAGRA.

VIAGRA may cause other side effects besides those listed on this sheet. If you want more information or develop any side effects or symptoms you are concerned about, call your doctor.

• Accidental Overdose

In case of accidental overdose, call your doctor right away.

• Storing VIAGRA

Keep VIAGRA out of the reach of children. Keep VIAGRA in its original container. Store at 25°C (77°F); excursions permitted to 15-30°C (59-86°F) [see USP Controlled Room Temperature].

• For More Information on VIAGRA

VIAGRA is a prescription medicine used to treat erectile dysfunction. Only your doctor can decide if it is right for you. This sheet is only a summary. If you have any questions or want more information about VIAGRA, talk with your doctor or pharmacist, visit www.viagra.com, or call 1-888-4VIAGRA.



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September 2002

The BusinessWeek Best-Seller List

HARDCOVER BUSINESS BOOKS			LAST MONTH	MONTHS ON LIST	PAPERBACK BUSINESS BOOKS			LAST MONTH	MONTHS ON LIST
1	THE 8TH HABIT Stephen R. Covey (Free Press • \$26) <i>In the new workplace, leaders must demonstrate trust, respect, and openness.</i>	—	1		1	WHAT COLOR IS YOUR PARACHUTE? Richard Nelson Bolles (Ten Speed • \$17.95) <i>The 2005 edition of the enduring job-search bible.</i>	—	1	
2	TRUMP: THINK LIKE A BILLIONAIRE Donald J. Trump, with Meredith McIver (Random House • \$21.95) <i>Tips on real estate, investing—and relationships.</i>	3	2		2	EFFECTIVE PHRASES FOR PERFORMANCE APPRAISALS James E. Neal Jr. (Neal Publications • \$10.95) <i>How about "attaboy"?</i>	8	19	
3	HOW FULL IS YOUR BUCKET? Tom Rath, Donald O. Clifton, PhD (Gallup Press • \$19.95) <i>Accentuating the positive at work.</i>	4	4		3	THE ABCs OF REAL ESTATE INVESTING Ken McElroy (Warner Business • \$16.95) <i>Stories from the real estate frontlines.</i>	1	3	
4	CONFRONTING REALITY Larry Bossidy, Ram Charan (Crown Business • \$27.50) <i>Zoning in on your business model.</i>	9	2		4	ZERO DEBT Lynette Khalfani (Advantage World Press • \$14.95) <i>An action plan to overcome money worries.</i>	—	1	
5	THE TOTAL MONEY MAKEOVER Dave Ramsey (Thomas Nelson • \$24.95) <i>Getting rid of debt and building up your rainy-day reserves.</i>	—	8		5	NICKEL AND DIMED Barbara Ehrenreich (Owl Books • \$13) <i>How the working poor have to struggle to make ends meet.</i>	2	23	
6	THE LITTLE RED BOOK OF SELLING Jeffrey Gitomer (Bard Press • \$19.95) <i>A syndicated columnist on why people buy.</i>	5	3		6	SMART COUPLES FINISH RICH David Bach (Broadway • \$14.95) <i>Managing your money after you've tied the knot.</i>	4	14	
7	THE AUTOMATIC MILLIONAIRE David Bach (Broadway • \$19.95) <i>How to put your investment program on autopilot.</i>	10	11		7	GETTING THINGS DONE David Allen (Penguin • \$14) <i>Organizing your office and managing your time.</i>	6	9	
8	THE NEXT GREAT BUBBLE BOOM Harry S. Dent Jr. (Free Press • \$26) <i>Attention, investors: Good times are just around the corner.</i>	8	3		8	THE MILLIONAIRE REAL ESTATE AGENT Gary Keller with Dave Jenks and Jay Papasan (McGraw-Hill • \$19.95) <i>Models that can make a real estate career soar.</i>	9	7	
9	CONFIDENCE Rosabeth Moss Kanter (Crown Business • \$27.50) <i>Rising to the occasion, by a Harvard B-school professor.</i>	1	3		9	SMART WOMEN FINISH RICH David Bach (Broadway • \$14.95) <i>Spending wisely and getting prepared for the future.</i>	5	12	
10	THE DAILY DRUCKER Peter F. Drucker (HarperBusiness • \$19.95) <i>Day-by-day inspiration from the management guru.</i>	—	1		10	HOW TO BE A QUICK TURN REAL ESTATE MILLIONAIRE Ron LeGrand (Dearborn • \$21.95) <i>Sell houses fast, fast, fast.</i>	—	2	
11	CAROLYN 101 Carolyn Kepcher, with Stephen Fenichell (Fireside • \$21.95) <i>Career advice from an adviser to the Donald.</i>	2	2		11	THE TOTAL MONEY MAKEOVER WORKBOOK Dave Ramsey (Thomas Nelson • \$17.99) <i>Quickie budgets, cash flow plans, and retirement investing.</i>	—	1	
12	THE FRED FACTOR Mark Sanborn (Currency/Doubleday • \$14.95) <i>The mailman's philosophy of work and life.</i>	12	8		12	THE ABCs OF GETTING OUT OF DEBT Garrett Sutton, Esq. (Warner Books • \$16.95) <i>"Real life" stories on how to do it.</i>	—	1	
13	SUN TZU WAS A SISSY Stanley Bing (HarperCollins • \$19.95) <i>The humorist strikes again, this time nailing the business-as-war crowd.</i>	—	1		13	THE GREAT UNRAVELING Paul Krugman (Norton • \$14.95) <i>A Princeton University economist takes on the Bush Administration.</i>	—	1	
14	THE ONE MINUTE MANAGER Kenneth Blanchard, PhD, Spencer Johnson, M.D. (Morrow • \$19.95) <i>Three management techniques, conveyed in brief story form.</i>	15	8		14	THE 48 LAWS OF POWER Robert Greene (Penguin • \$17) <i>Rules for strivers, drawn from the likes of Machiavelli, Catherine the Great, and Henry Kissinger.</i>	11	13	
15	THE PRESENT Spencer Johnson (Doubleday • \$19.95) <i>The pursuit of happiness and success, described in a fable.</i>	—	12		15	J.K. LASSER'S YOUR INCOME TAX 2005 The J.K. Lasser Institute (Wiley • \$16.95) <i>With recent IRS announcements.</i>	—	1	

LONG-RUNNING BEST-SELLERS

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DISCOVER YOUR STRENGTHS Marcus Buckingham, Donald O. Clifton (Free Press • \$27)
CONFRONTING REALITY Larry Bossidy, Ram Charan (Crown Business • \$27.50)
MOVED MY CHEESE? Spencer Johnson (Putnam • \$19.95)
FIVE DYSFUNCTIONS OF A TEAM Patrick Lencioni (Jossey-Bass • \$22.95)
THE 7 HABITS OF HIGHLY EFFECTIVE PEOPLE Stephen R. Covey (Fireside • \$15)
THE TIPPING POINT Malcolm Gladwell (Back Bay • \$14.95)

FIRST, BREAK ALL THE RULES Marcus Buckingham, Curt Coffman (Simon & Schuster • \$27)

PAPERBACK BUSINESS BOOKS

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FAST FOOD NATION Eric Schlosser (Perennial • \$14.95)

THE 7 HABITS OF HIGHLY EFFECTIVE PEOPLE Stephen R. Covey (Fireside • \$15)

THE TIPPING POINT Malcolm Gladwell (Back Bay • \$14.95)

THE E-MYTH REVISITED Michael E. Gerber (HarperBusiness • \$16)

THE RICHEST MAN IN BABYLON George S. Clason (Signet • \$6.99)

RICH DAD'S CASHFLOW QUADRANT Robert T. Kiyosaki, with Sharon L. Lechter (Warner • \$17.95)

THE MILLIONAIRE NEXT DOOR Thomas J. Stanley, William D. Danko (Pocket Books • \$15)

GETTING TO YES Roger Fisher, William Ury, Bruce Patton (Penguin • \$15)

RICH DAD'S GUIDE TO INVESTING Robert T. Kiyosaki, with Sharon L. Lechter (Warner • \$19.95)

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News and more are available on AOL (Keyword: BW) or www.businessweek.com



BY STEPHEN H. WILDSTROM

Will ThinkPads Still Be ThinkPads?

ThinkPads have been my favorite laptops for a long time. Smart design, reliability, and the best keyboards in the business meant that when I picked a notebook for my own use, it was usually one of IBM's iconic black boxes. So the news that IBM, which did so much to create the personal computer, was selling its PC operations to China's Lenovo left me saddened.

Nostalgia aside, many ThinkPad buyers may be concerned about the future. IBM is a familiar partner of Corporate America. What does the shift in ownership to a company partly controlled by the Chinese government mean? Will ThinkPad quality suffer? How much confidence will there be among corporate customers, whose purchasing decisions often commit them to buying the same products for the next 18 months or more? After discussing the deal with top executives of the new Lenovo, I'm cautiously optimistic. ThinkPad should remain the product it has been and, if we are lucky, could return to being the innovator it once was.

In financial terms, the deal looks like a straightforward purchase of IBM assets by Lenovo. Functionally, IBM looks more like the buyer. Operations will be based in Research Triangle Park, N.C., near the division's current home, and most operating execs will be IBMers. Among the assets going to Lenovo are all IBM's PC design facilities, including an innovative lab in Yamato, Japan. In addition, Lenovo either acquires outright or gets licensing rights to a large portfolio of IBM patents, a development that may encourage the Chinese to start being more respectful of intellectual property rights.

THE CHANGE IN THINKPAD'S nationality may not be significant in terms of production issues. Most ThinkPads will continue to be built in an IBM-owned plant in Shenzhen, China. Furthermore, the competing products from Dell, Hewlett-Packard, and others are built by Asian contract manufacturers, mostly in China. My bet is that Lenovo will maintain the quality that ThinkPad customers have come to expect, while IBM takes care of customer service and support.

The future of product design is less clear. IBM didn't invent the modern laptop, but the company played a huge role in perfecting it, and a hallmark of the glory days was a willingness to experiment. Some products, such as the ThinkPad 701C, with its expanding "butterfly" keyboard, were



INNOVATIVE
But the
IBM 701C
didn't sell

critical successes that didn't sell well. Others, such as the thin ThinkPad 600 of 1999, were commercial winners that redefined their markets. But in recent years, IBM's PC group has struggled in a low-margin business in a high-margin company, starved for investment funds and unable to take the chance on interesting products with an assured market.

Could Lenovo revive risk-taking and experimentation in business laptops? Strong forces are working against it. The business has matured. Dell's

determination to keep R&D expenditures to a minimum and relentlessly squeeze out costs is going away. Neither is a corporate purchasing process that has pushed Dell, HP, and IBM to offer models with similar designs and mostly identical features.

Most of the recent design experimentation in business laptops has come from side Asian players, including Acer, Fujitsu, and Panasonic, not the Big Three. Lenovo seems unlikely to blaze new trails. Still, the company will have a lot of design talent and, perhaps, the freedom to innovate.

New Chinese owners aren't likely to sacrifice quality

As a U.S.-Chinese business partnership, Lenovo is a leap into the unknown. The Chinese owners could let quality suffer. The American executives who built ThinkPad could drive away. But so far, the top managers of the new Lenovo seem excited to be escaping the IBM yoke for a company focused on PCs. So I believe we can still buy ThinkPads with confidence and maybe we'll see better things in the future. ■■

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BY LAURA D'ANDREA TYSON

Social Security Crisis? What Crisis?

Is the Social Security system facing a crisis? President George W. Bush certainly wants us to think so. Indeed, he recently warned that the "crisis is now." After years of repeated warnings by conservative political thinkers, the word crisis has become the mental frame that shapes the way many Americans think about Social Security's future. But as a recent Brookings

Institution book by Peter A. Diamond and Peter R. Orszag demonstrates, Social Security does not confront a crisis; in fact, its solvency for future generations can be ensured through modest benefit reductions and modest revenue increases.

To defuse the crisis hype it is useful to begin with a few facts. First, Social Security is a significant source of income for elderly Americans, providing the majority of income for two-thirds of elderly beneficiaries and all of the income for 20% of them. Second, according to the most recent report by the Trustees of Social Security, even under the cautious assumption that the U.S. economy grows at the anemic rate of 1.6% a year, the revenues into Social Security from the current level of payroll taxes will cover promised benefits for another 38 years and will be enough to finance about 70% of benefits through 2078. The net present value of the shortfall in revenues over the next 75 years is \$3.7 trillion, only about one-third of the net present value of the Bush tax cuts of 2001 and 2003 and about 0.7% of gross domestic product projected for the same period. An immediate payroll tax increase of about 2% would eliminate this gap. So would paring the Bush tax cuts of 2001 and 2003 back by less than 50%, and transferring the added revenues to Social Security.

THIRD, THE PROJECTED financing gap in Social Security is not the result of overly generous benefits. Under current law, projected benefits are slated to fall from only 33% of previous earnings for an average worker of 62 today to a low 29% by 2030. And retired workers with low lifetime earnings as well as disabled workers and their families often live in poverty despite Social Security's progressive benefit formula. Any proposal to restore solvency through benefits cuts alone would require a 20% reduction in payouts in addition to the declines built into current law, sharply increasing poverty rates among future beneficiaries (assuming that the disabled and those presently 55 and older are exempt).

In contrast, Diamond and Orszag propose a plan that calls for modest cuts in overall benefits, some improved treatment of the most vulnerable categories such as workers with low lifetime earnings, and a gradual increase in the combined employer-employee payroll tax rate from 12.4% today to 13.2% in 2035 and 15.2% in 2075. Benefits for the average

worker aged 45 today would be cut by about 1%, and for the average worker aged 25 today by about 9%, relative to currently scheduled benefits. However, the level of inflation-adjusted benefits would continue to rise.

A major lesson of this analysis is that Social Security is put on a solid financial footing without dramatic changes. In contrast, President Bush is using the specter of an impending crisis to justify allowing workers to divert up to 4% of their payroll taxes into private, individually controlled retirement accounts. This would reduce payroll tax revenues available to cover promised Social Security benefits by as much as \$2 trillion to \$4 trillion, transforming an imaginary crisis into a real one. The Bush Administration has recently indicated that

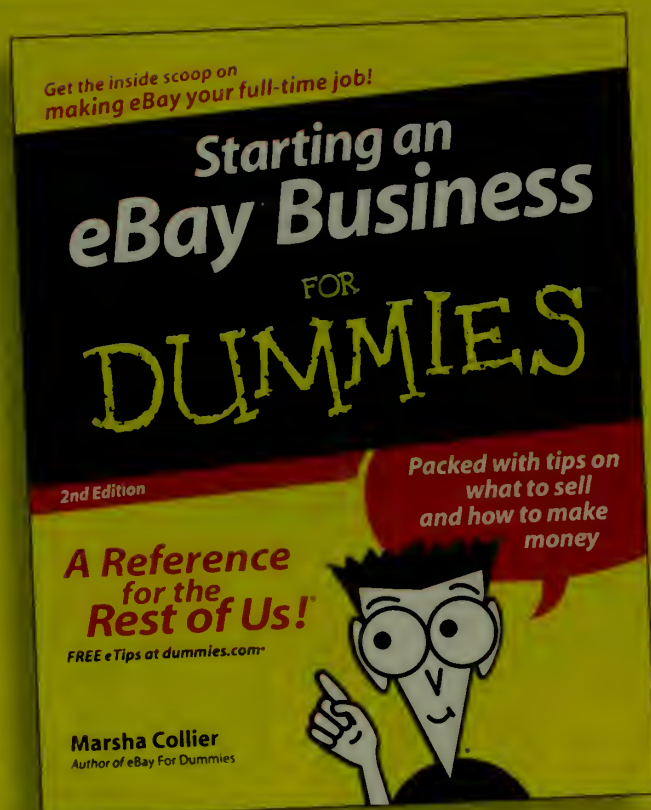
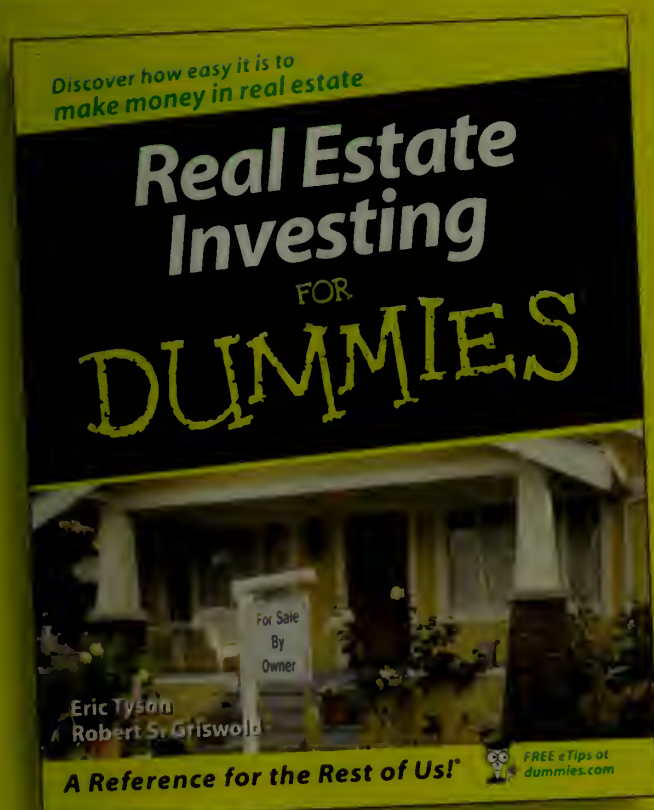
Modest benefit cuts and revenue increases would solve the shortfall

plans to finance these transition costs of creating private accounts through additional government borrowing. But the amounts involved are as much as an additional \$100 billion a year in government borrowing for the next decade, rising to \$350 billion a year after 20 years. Additional borrowing of this magnitude on top of already large government deficits could spook global investors, trigger sharply higher interest rates on U.S. government debt and a collapsing dollar. But President Bush has been silent about the possibility of such a crisis. He has also been silent about the fact that individual accounts would require paying financial management fees that could amount to more than 25% of Social Security's current 75-year funding gap.

For nearly 70 years, Social Security has provided all working Americans with a basic level of income protection against inflation, financial market fluctuations, not to mention the risks of disability, losing a family wage-earner, or outliving one's assets. With a few modest changes, it can continue to deliver this remarkable security. There is no crisis. ■

Laura D'Andrea Tyson is dean of London Business School (ltyson@london.edu).

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JAMES C. COOPER & KATHLEEN MADIGAN

The Walls Won't Come Tumbling Down

Mortgage rates in 2005 will remain low enough to keep housing affordable

U.S. ECONOMY Housing, Americans' favorite investment, faces a rough year in 2005. After three years of torrid increases, both starts and sales seem set to fall this year. The key question is: by how much? A hint of a big decline came in the news that housing starts plunged 11% in November, while new home sales fell 12%. And economists

cited by *BusinessWeek* last month listed the bursting housing bubble as one possible shock for 2005. But it should be noted that most forecasters give such a scenario a low probability—and with good reason. The construction and demand will probably slow this year, but the fundamentals argue that neither will fall by much. The bond market has already priced in a gradual tightening of monetary policy. That means mortgage rates are unlikely to rise much, and affordability should be boosted from stronger job and income growth. As for those November numbers? Much of the pessimism can be traced to extremely wet weather. The available December data suggest a bounce back. The National Association of Home Builders/Wells Fargo Housing Market Index climbed to its highest level in more than a year in December, with sales expectations rising. And despite a steep drop in the holiday-shortened week in December, mortgage applications to buy a home remained for the entire month on a par with the November average, which was up 2.8% from October. That this means for the outlook is that housing won't subtract much, if anything, to overall economic growth. It also won't subtract much from growth, which ended 2004 with a good deal of momentum, given the strong December reports from the nation's housing managers and the jump in December vehicle sales. More important, demand should remain healthy enough to give home prices at least a small lift in 2005. It will increase household wealth and confidence. To be sure, the one thing that could wreck the housing outlook would be a slump in the bond market that would send long-term interest rates soaring. Bond traders are becoming a bit more anxious after the surprisingly bullish tone on inflation in the minutes of the Federal Reserve's Dec. 14 policy meeting, which suggested a later resolve to push rates higher. Nevertheless, the minutes did not suggest a deviation from the Fed's recent pattern of quarter-point hikes at each meeting.

BACK TO THE KEY QUESTION: How much will housing slip in 2005? According to the forecasts from the economic teams who watch the housing market closely, the National Association of Realtors, the

Mortgage Bankers Assn., and Fannie Mae, construction and sales won't see dramatic falloffs. The experts also say prices should keep rising, although at a slower pace (table). So, while some housing markets in the U.S. show signs of overheating, homeownership generally will remain an attractive investment in 2005.

Granted, these groups have vested interests in presenting

an upbeat assessment of housing. But their outlook for housing starts is not out of line with the consensus forecast of economists in the Blue Chip Economic Indicators survey, which expects homebuilding to fall 6%.

As usual, mortgage rates will be the key driver in this year's housing market. Indeed, housing's surprising strength in 2004 stems

primarily from the failure of long-term interest rates to rise as widely expected. As a result, 30-year mortgage rates averaged 5.8% last year, the same as in 2003.

For 2005, long-term rates are sure to rise, reflecting a strong economy, an expectation of slightly higher inflation, and an expected "measured pace" of Fed tightening. The housing trade groups see long-term interest rates increasing by just over half a percentage point. The Blue Chip consensus forecasts a rise of about three-quarters of a point.

EVEN IF LONG RATES move up in 2005 according to current expectations, mortgage rates will remain low enough to keep housing affordable. Movements in 30-year fixed mortgage rates are tightly correlated with the yield on 10-year Treasury bonds. Based on their historical relationship, if the 10-year Treasury yield averages 4.8%, as expected by the Blue Chip survey of economists, that yield would imply an average mortgage rate of only 6.4%.

Consider a home costing \$190,000, close to the median price of an existing home expected in 2005, and a

HOUSING: WHAT'S IN STORE FOR 2005

	2004	2005
Starts (millions)	1.94	1.84-1.87
Sales (millions)		
New	1.19	1.06-1.13
Existing	6.61	5.99-6.38
Median Price (% change)		
New	12.1	3.3-5.8
Existing	7.6	3.2-5.0

2004 estimate, 2005 forecast
Data: National Association of Realtors,
Mortgage Bankers Assn., Fannie Mae

20% down payment. An increase in the mortgage rate from 5.8% in 2004 to 6.4% in 2005 would boost the monthly payment of that mortgage by only \$60, to about \$950. Given the median household income of about \$55,000, that higher payment now would take up about 21% of the household budget, up from about 19%. That is still well below the 25% cutoff that lenders tend to follow in their mortgage approval process.

In fact, mortgage rates would have to go above 8% before the monthly payment would breach the 25% limit. Only then would higher rates begin to put home buying out of reach for a large number of people. But based on the historical relationship between mortgage rates and Treasuries, an 8% mortgage rate could exist only if the yield on 10-year Treasury bonds soared to 6.5%, from 4.2% currently (chart). Given the most likely paths for inflation and Fed tightening, a bond market collapse of that magnitude is highly unlikely.

IN ADDITION, PRICES AND RATES account for only one side of the affordability equation. Even as higher rates push up monthly mortgage payments, households will be in better shape to cover the extra cost. If hiring picks up as expected in 2005, incomes will grow more closely in line with increases in home prices.

In 2004 yearly payroll employment rose for the first time since 2000, averaging more than 180,000 new slots per month. As a result, median household income, which advanced only 1.9% in 2003, grew at a faster 3.3% clip last year. In 2005 employment gains should at least

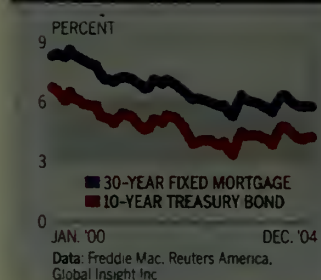
match their 2004 pace, and, with job markets tight, pay rates will rise faster. That means median family income is sure to accelerate as well.

Favorable demographic factors will also continue to support housing demand, especially in the second-half market. Baby boomers are snapping up vacation homes

that will someday be retirement homes.

According to the National Association of Realtors, tax law changes in 1997 which allowed sellers to exclude up to \$500,000 in capital gains from taxation under certain circumstances, coincided with boomers entering their peak second-home buying years. The result has been an explosion

MORTGAGE RATES WILL FOLLOW BOND YIELDS



demand that has sent sales—and prices—soaring on the coasts and in other desirable retirement areas.

For 2005, despite the prospects of higher interest rates, home buyers and builders can rest easy. Rates are rising because the economy is strong. To be sure, housing demand will ease back a notch, but even that could have long-run benefits to the extent that it lets a little air out of the home-price bubble in some areas. The housing boom may finally be over, but this is one boom that will not bust anytime soon. ■

FRANCE

Not a Lot of Gas in This Job Engine

WILL A NEW YEAR mean more new jobs for French workers? President Jacques Chirac has made better employment growth a focus for 2005. But private economists are skeptical that France can grow fast enough to generate a pickup in hiring.

In the second half of 2004 the economy wrestled with higher energy prices, which hurt domestic demand, and a strong euro, which curbed export growth. Final revisions to the data show that real gross domestic product did not grow at all in the third quarter. Consumer spending fell even more than first estimated.

Growth probably was weak in the fourth quarter, meaning the economy grew less than 2% for

all of 2004. The slowdown is hitting the job markets. November's jobless rate stayed at a high 9.9%, above the 8.9% rate for the total euro zone. With work prospects dismal, confidence was weak at yearend. Spending held up, mainly because of tax breaks and rebates for car buying.

In his traditional New Year's Eve speech, Chirac vowed to make job creation a priority in 2005. Prime

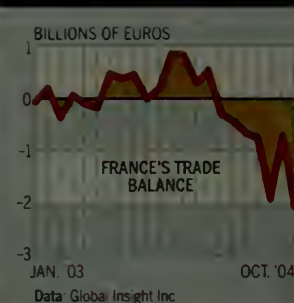
Minister Jean-Pierre Raffarin has said the jobless rate will fall to 9% by yearend. That forecast is partly based on the tax cuts and labor reforms—such as giving more flexibility to the 35-hour workweek rule—which could prompt more hiring.

Raffarin also said France's real GDP will

expand by 2.5% this year. But private economists, as well as the Organization for Economic Cooperation & Development, see growth at 2% or less. That pace is simply not strong enough to create enough new jobs to reduce the unemployment rate by one percentage point. The OECD, for example, forecasts the jobless rate will fall only to 9.5%.

Moreover, France's economic prospects will be stymied by any further strengthening of the euro, which makes French exports more expensive. Export growth has slowed even as imports are soaring. In October the trade deficit hit a record high of 2.1 billion euros (\$2.6 billion). Weak foreign demand is weighing on business sentiment as well. The confidence index for manufacturing declined again in December as foreign orders stayed in negative territory. ■

A WIDER TRADE GAP IS SLOWING GROWTH





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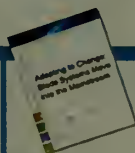


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GOVERNANCE

DEATH, TAXES & SARBANES-OXLEY?

Executives may be frustrated with the law's burdens, but corporate reform is here to stay

NEARLY THREE YEARS ago, Congress set out to clean up the way companies do business after accounting and governance scandals rocked investor confidence and damaged the reputation of companies large and small. Now, as the final stages of reform mandated by the Sarbanes-Oxley Act 2002 go into effect, much of Corporate America is in an uproar. CEOs and CFOs complain they're burdened with huge implementation costs as armies of nitpicky auditors check every corner of their operations. "Common sense is gone," says Wisconsin Energy Corp. controller Stephen P. Dickson, voicing an increasingly common gripe. "You have to document everything."

True enough, it hasn't been the easiest

year for CFOs and their staffs. And there's no denying that the costs of implementing Sarbanes-Oxley are high—upwards of \$35 million on average for large companies this year alone. Complicating matters, the promised benefits of the reform movement are hard to spot and difficult to quantify: frauds that never happened, or the boost to investor confidence that has helped bring life back to U.S. markets.

WORTH THE TROUBLE

FEARS HAVE THUS taken hold that a backlash is under way. Clearly, executive complaints are reaching Washington: The U.S. Chamber of Commerce has targeted Securities & Exchange Commission Chairman William H. Donaldson and is compiling a dossier of examples of what it calls regulatory or enforcement overreach. And concern that the Administra-

tion's appetite for reform—or support for Donaldson—could wane in the short term were stoked in mid-December by Treasury Secretary John W. Snow's call for more "balance" in regulation.

Yet despite the grumbling, there's increasing evidence that reform has been well worth the trouble. Already, increased scrutiny of accounting methods and internal controls has unearthed long-hidden problems in the way companies operate. And fixing weak financial controls has nipped a lot of accounting problems in the bud. "You know the CEOs and CFOs are doing much more due diligence on the side of their companies," says John Bukspan, chief accountant for Standard & Poor's, the credit-rating service. Perhaps most important, the reforms have helped renew investor confidence in companies' reports—a payoff that

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further behind



grow in time. Says Donaldson: "The benefit will come in the long haul, with greater credibility in the marketplace and higher stock price multiples."

What's more, there's little chance that the SEC will be reined in. Following Fannie Mae's \$9 billion restatement and continued controversy over megamillion-dollar parachutes it handed ousted top execs, corporate scandal is still too fresh to allow politicians to backtrack. The White House made it clear on Dec. 16 that the President "appreciates" the job Donaldson is doing to crack down on corporate wrongdoers. Snow has affirmed his support for Sarbanes-Oxley and Donaldson—although he still thinks regulators and prosecutors need to better coordinate their rulemaking and probes. "The system may have become too prosecutorial," Snow told *BusinessWeek* on Jan. 4.

Nevertheless, the complaints, which have been growing through the fall, will probably intensify in coming weeks due to widespread frustration with a single feature of Sarbanes-Oxley, Section 404. It requires that corporate executives and their auditors document, and certify to investors, that their internal financial controls work properly. It is biting hardest now because the first deadlines for completing the work begin taking effect next month for large-cap companies.

The law requires, for example, proof that someone is cross-checking the numbers that make up earnings, such as the value of inventory and receivables. Seems reasonable enough, but execs grouse that auditors are applying the law in mind-numbing detail. "It requires an army of people to do the paperwork," says William D. Zollars, chairman and CEO of

Yellow Roadway Corp., the nation's largest trucking firm. Zollars dispatched some 200 Yellow employees to the task last quarter and paid about \$9 million to accountants for their work—or some 3% of annual profits for 2004.

Costs vary across companies, depending mostly on their complexity, auditors say. A survey of board members conducted by RHR International for *Directorship*

has been a major drag on the economy, Gabelli says. But small public companies may have the best argument, since they have fewer revenues to offset basic compliance costs. "This is a regression against small business," says venture capitalist Gary J. Morgenthau of Menlo Park (Calif.)-based Morgenthau Ventures.

While accountants predicted that the internal controls section of Sarbanes-Oxley would be a burden for a few people except there to be this grief. After all, Section 404 restates what already required by other federal law and regulations. Since the late '70s, the Federal Corrupt Practices Act has required companies to have internal controls, and auditors have long been expected to test them before signing off on financial statements.

Sarbanes-Oxley adds the requirement that executives and auditors certify the controls work. Lawyers did that to ensure that top managers were held accountable for problems and to make it easier to prosecute cheaters. "The fact that companies are having difficulty complying, after controls have been in federal law for 25 years, does speak well for the quality of their controls," says one high-ranking regulator.

That may be an understatement. In November, 119 companies publicly reported finding weaknesses or deficiencies in their internal controls, up from 10 the same month a year before, according to industry newsletter *ComplianceWeek*. Many problems involved closing books, reconciling accounts, or dealing with inventory. SunTrust Banks Inc. said in November that it had fired three officers for discovering errors in how it calculated

“The benefit will come in the long haul, with greater credibility in the marketplace and higher stock price multiples”



—William H. Donaldson
Chairman, Securities & Exchange Commission

magazine found that big companies with \$4 billion or more in revenues are spending an average of \$35 million to comply with the act. Another survey by Financial Executives International found \$3.1 million in added costs for companies with average revenues of \$2.5 billion.

SMALL-BIZ HARDSHIP

THOSE NUMBERS ARE grist for lobbyists in Washington. The U.S. Chamber of Commerce is collecting such evidence to take to Congress. The group's top priority this year is a "push back" for changes in Sarbanes-Oxley, says David T. Hirschmann, senior vice-president of the Chamber. He'll probably have plenty of ammunition. Mario J. Gabelli, CEO of Gabelli Asset Management, says he put off hiring 12 security analysts in order to pay for complying with Section 404. "It

Sarbanes-Oxley: An Assessment

MEETING THE COSTS

Big companies are spending some \$35 million on average to comply with auditing-disclosure requirements. As they become accustomed to the new regs, however, costs should drop sharply.

GETTING THE JOB DONE

Compliance is hugely time-consuming; complaints about redundant paperwork and nitpicky auditors abound. But the workload should ease with experience and more practical assessments by auditors.

SPOTTING TROUBLE

Despite the complaints, hundreds of companies say they have uncovered festering accounting problems while implementing the regs. Others have found redundant administrative spending.

EASING THE BURDEN

The difficulties and cost of implementing Sarbanes-Oxley can be particularly heavy for smaller businesses. But the SEC is giving them extra time to comply—and will review other complaints in the spring.

ances for losses in loan portfolios. teon Corp., a car-parts supplier, said found problems recording and managing accounts receivable from its manufacturer, Ford Motor Co. It's now fixing those problems. "We are finding the focus on internal controls is uncovering problems at the best of companies," says Samuel A. DiPiazza Jr., CEO auditor PricewaterhouseCoopers International Ltd.

MORE CONFIDENCE'

NY BUSINESSES are discovering the benefits. General Electric Co., which spent about \$30 million on the work last year, "had good controls before this, but it has added more rigor," says CFO Keith S. Sherin. "It certainly helps [CEO Jeffrey R. Immelt] and me restore confidence when we're signing off on the results." United Technologies Corp. used the work to standardize checks on bookkeeping in its disparate businesses around the world. "We had a degree of latitude in how people do important things. We've tightened that," says Jay Haberland, UTC's vice-president for business controls.

The biggest advantage of all, though, may be the greater confidence investors have in financial results. "The auditors are doing better audits and charging for it. More questions are being asked by everyone," says Donald T. Nicolaisen, the CA's chief accountant. That's why fine-tuning the regs, rather than any kind of backlash, is what's likely this year. Regulators are encouraging auditors to focus on critical issues that pose the biggest risks rather than sweating the little stuff that wastes time and resources—and gives managers nuts. And come the spring, they have promised to review the complaints and determine whether the procedures can be improved.

Some officials say it could take three years for companies, auditors, and regulators to apply the law efficiently. That may seem like a long march for many executives. Yet in the long run, it will be small price to pay for more smoothly running organizations and renewed investor confidence. ■

By David Henry in New York and by Borris in Washington, with Louis Velle and Diane Brady in New York, Michael Arndt and Joseph Weber in Chicago, and bureau reports

GOVERNANCE

PROFITING FROM THEIR MISTAKES

Software makers' programs to fix their own accounting problems are hot sellers

SINCE JEFFREY CLARKE reported for duty at software maker Computer Associates International Inc. last April, he has spent much of his time fixing a financial system so flawed it allowed former employees to overstate revenues to the tune of more than \$1 billion. "This is a company where the checks and balances failed. We're putting them in," says Clarke, CA's chief operating officer and acting chief financial officer. He not only hired a handful of controllers and internal auditors but also is using CA's own storage and asset-management software to ensure compliance with Sarbanes-Oxley rules and other financial regulations. It's a case of software company, debug thyself.

Such regulatory compliance has also added a healthy glow to CA's bottom line. While many companies gripe that complying with Sarbanes-Oxley has meant nothing but expense, for CA and other tech outfits, the rules have helped create a booming new market. They sell lots of software that helps other organizations comply with Sarbanes-Oxley by tracking assets, storing data, and searching for documents.

It's a growth business in a mature industry: Market researcher Gartner Inc. expects spending on corporate-governance software to hit \$6.9 billion in '06, more than double last year's tally. Gartner says much of the spending so far on Sarbanes-Oxley compliance has gone to consulting firms doing quick fixes, but it ex-



CA's CLARKE

pects companies to eventually use software to manage their oversight processes. Even then, instead of a single software package for handling compliance, there will be a patchwork of individual products.

In an odd twist, several software makers selling compliance-related products ran into accounting problems of their own in the past—giving them an intimate understanding of how software can help prevent accounting lapses.

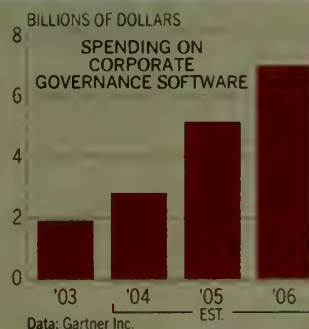
In addition to CA, these companies include Peregrine Systems, Veritas Software, MicroStrategy, and Legato Software, which is now part of storage giant EMC. "It's ironic that some players providing the technology that manages compliance also had compliance issues themselves," says

Gartner analyst Joanne M. Correia. "The important question is, have they learned from their own experiences in ways that help their customers?"

CUSTOMER RAVES

INDEED THEY HAVE, say both software execs and their customers. Peregrine spent nearly nine months gathering records to see if it had paid Microsoft Corp. the proper amount in annual subscription fees. It hadn't. Incredibly, Peregrine wasn't even using the latest version

A BOOMING MARKET



BusinessWeek online For more on Sarbanes-Oxley, including an interview with Treasury Secretary John Snow, go to www.businessweek.com/extras

of its own asset-management software product, which tracks contract obligations with suppliers. Now it does. And Peregrine next month will launch a new version that makes it easier for clients to track their use of computers and software, issue reports, and record the proper sign-offs by executives on a quarterly basis—as required by Sarbanes-Oxley.

Customers rave about the technology. J. P. Morgan Chase & Co. has had to prepare to comply with Sarbanes-Oxley at the same time it is completing its merger with Bank One Corp. It's using Peregrine's asset-

management product to smooth the transition and plans on updating to the new version. Mark Bradley, the bank's application development analyst in charge of Peregrine products, says key features include

Another winner: EMC's e-mail indexing software

graphics that take an exec step by step through the process of tracking contract compliance, which can then be shown to an auditor if necessary. "The biggest part of compliance is showing you have done your work," says Bradley.

For Legato, a Securities & Exchange Commission investigation and shareholder suits in 2000 taught a punishing lesson about the difficulty of searching millions of old e-mails in a hunt for a handful of potentially incriminating ones. It took months and hundreds of thousands of dollars to do the job. That experience prompted Legato in 2002 to purchase OTG Software Inc. for its e-mail archiving technology. Now EMC, which itself bought Legato last year, counts among its offerings software that lets corporate customers create vast storehouses of e-mails, index them, and search them by name, topic, and date.

For software companies with troubled pasts, it's sometimes awkward to hawk compliance software. Customers want to talk through their suppliers' problems and understand what they did wrong. "At first there was embarrassment. You don't feel good about it," says George Symons, chief technology officer for information-management products at EMC and a former Legato executive. "But you can turn a negative into a positive." And potentially into a lot of money. ■

—By Steve Hamm in New York

ACCOUNTING

TIME TO START WEIGHING THE OPTIONS

New FASB rules make stock options an expense. How will companies cope?

WITH THE LONG-awaited decision by the Financial Accounting Standards Board in December requiring U.S. companies to expense their stock options, one of the great accounting debates of all time has ended. Barring congressional intervention, by July most public companies will begin treating stock options as an expense. But that doesn't mean the battle is over. Instead, companies that use options are gearing up for the next round: cutting their expense by any means legally possible.

WIGGLE ROOM

THE DIFFICULTY OF PUTTING a value on stock options should give them plenty of wiggle room. Unlike other forms of pay, the expense associated with stock options is simply an estimate of future value. By changing the assumptions underlying that estimate—reducing the assumed volatility of the underlying stock, say, or trimming the duration of an option—companies can dramatically reduce the expense they must book and minimize the hit to earnings. Changing the length or vesting period of the options themselves can produce a similar

impact. In the past, says Jack T. Ciesielski, publisher of *The Analyst's Accounting Observer*, many companies went to great lengths to avoid the negative effect on the bottom line. "Now the consequences are more severe," he says. "As a consequence, and they're taking steps to manage [it]," says Ciesielski.

No industry has objected to the new rules more than high tech, which depends on options for a larger chunk of compensation than do other sectors. So tech companies are taking steps that will result in reduced option costs. One way is to lower the assumption made about how volatile the company's underlying stock is, since volatility—a measure of how much a stock price fluctuates—is a key component of Black-Scholes, the commonly used formula for estimating an option's value.

A new study of 93 Silicon Valley companies by pay researchers Equilar found that two out of three trimmed their volatility assumptions over the last three years, with a median decrease of 14%. By comparison, less than half of the companies in the Standard & Poor's 500 stock index lowered their volatility assumptions over the same period, with a median decrease of 10%.

Of course, cutting volatility estimations

Buzz Cut

How companies are trimming option expenses:

LOWER VOLATILITY By predicting that their stocks will be less volatile, companies can cut the options' value

SHORTEN OPTION LIFE Assuming that workers will exercise options earlier—or awarding options that expire sooner—gives a big break in costs

EARLY VESTING Allowing options to vest immediately reduces the number that have to be expensed under new rules

LENGTHEN VESTING By awarding options over a longer period, companies can spread out their costs



many cases makes sense, given that stock performance has often been less predictable than it was in prior years. But whatever the rationale, the impact on option expenses is clear. Consider the case of Ciena Corp., a Linthicum (Md.) maker of optical networking gear. Ciena has cut its assumed volatility in half, from 131% in 2001 to as low as 63% in 2004. The change reflected less volatile trading in Ciena shares as their price dropped from \$15 in late 2000 to less than \$3. The lower volatility assumption, along with the flattening of stock price, helped reduce its option expenses a staggering 90%, from \$19.92 per share to \$2.82—and by itself would have cut the cost of the 37 million options it granted in 2004 by an estimated \$60 million. Company spokeswoman Anne DuLong says the volatility assumption reflects reality. “The stock has been a lot less volatile than it was in the past few years,” she says. Another favorite tactic: reducing the expected life of options by cutting the number of years that employees are ex-

at Advanced Micro Devices Inc. received options with seven-year terms, down from the 10 years on options the company awarded a few months earlier. AMD declined to comment.

Changing vesting schedules can also trim options costs. Since options are expensed over the vesting period, one way to reduce the annual hit to earnings—although not the overall cost of the options—is to lengthen the vesting period. In August, Cisco Systems Inc. did just that, awarding CEO John T. Chambers 1.5 million options that vest in seven years, up from five a year earlier. The company says the purpose was to provide a longer-term incentive, but the end result is the same: a smaller earnings hit each year.

SWAN SONG?

COMPANIES ARE discovering other strategies as well, some of which take advantage of the rules for the transition to mandatory expensing. Come July, most companies must expense all unvested options from previous years—a potentially massive hit to earnings. To avoid that, HCA Inc. last month opted to accelerate the vesting on more than 19 million underwater options that had not yet vested—eliminating what would have been \$83 million in expenses through 2008. In a statement, Chairman and CEO Jack O. Bovender Jr. said the move was “in the best interest of the company and its shareholders.”

In the post-expensing world, accounting methods used to reduce option expenses will make it more difficult for investors to evaluate earnings quality. Comparing companies or industries will become tougher, as investors will have to plow through footnotes to figure out which companies boosted earnings by tweaking accounting assumptions for options, which didn’t—and which changes were warranted.

But there’s a far simpler way to trim option costs that doesn’t involve changing option grants or accounting assumptions, and won’t have shareholders running for the aspirin: granting fewer options. Pay consultants say most companies are replacing some stock options with restricted stock, with the biggest changes happening at companies that have already begun expensing options. The trend will likely accelerate in 2005 as the biggest users of stock options—tech companies—face a future where such generosity comes with a hefty price tag. ■

—By Louis Lavelle in New York

THE STAT

65.6%

Share of tech companies in the past three years that cut the value of stock options by lowering the assumed volatility

Data: Equilar Inc.

pected to hold them before they are exercised. The lower number might reflect employees who exercise options before they expire or options that expire faster. Either way, it reduces the stock’s potential price appreciation, and therefore the value of the option. In all, Equilar says, nearly 28% of S&P 500 companies—and 33% of tech companies—have reduced option life assumptions during the past three years. In October, for example, executives

COMMENTARY

BY MICHAEL J. MANDEL

Our Hidden Savings

Americans don't set aside much. But include R&D and education spending, and the picture changes

LIVING BEYOND our means: The phrase is echoing through the halls of Washington and Wall Street, as politicians and economists try to encourage Americans to save more. Nearly every fiscal policy proposal now being floated—including expanded tax-deferred retirement accounts, the Bush Administration's plans to overhaul Social Security, and even a possible tax reform bill—is justified as a way to boost savings.

Certainly the numbers seem to show a savings crisis. Over the past year, the household savings rate has averaged a meager 0.8% of disposable income, the lowest level since the Great Depression. The national savings rate—which includes corporate savings and government budget deficits—is only about 13.6% of gross domestic product, also near a postwar low.

According to the conventional wisdom, such low savings rates threaten to undermine America's future. Weak savings means fewer funds are available to invest in productive machinery and equipment, which in turn leads to slowing long-term growth. Moreover, the argument goes, the lack of savings forces the U.S. to borrow heavily from overseas—driving a

growing trade deficit, and leaving the country more dependent on foreign funding that could dry up. And most American families seem to be shelling out far too much on cars and big homes today, rather than socking away enough for retirement.

Americans look especially imprudent when compared to their global rivals. National savings rates in Europe run around 20%, on average, while Japan saves around 25%. The International Monetary Fund estimates that China has a national savings rate of nearly 50%. Little wonder that Stephen Roach, chief economist at Morgan Stanley, recently wrote that "America's saving problem is off the charts—possibly the most serious imbalance in an unbalanced world."

Yet the savings rate is a misleading measure of future economic performance. In today's economy, education and innovation are the main engines of wealth-producing growth, not physical capital. Yet the official statistics count spending on education and research and development as consumption, not as an investment.

That's a crucial distinction, since an outlay that is counted as investment ends up increasing savings (box). For example, if U.S. companies buy new capital equipment, that bolsters the U.S. savings rate. But if those same companies hire more scientists and boost R&D, that spending would not be counted as investment or add to savings, even though it would spur long-run growth.

NUMBERS GAME

WHAT GOES IN THE PIGGY BANK?

On the face of it, the definition of personal or national savings seems simple. Take a household's or a country's income, subtract consumption, and savings is everything left over. Easy.

Ah, but look again: First, it's not obvious

how income should be measured. The Bureau of Economic Analysis omits capital gains from its definition of income. So the wealth created by rising home and equity values is not included in America's overall savings total.

More important, savings also depends on which outlays are logged as consumption or investment. The BEA has a specific list of purchases that count as investment: business and government spending on equipment, software, and buildings; and household outlays to build new homes or renovate existing ones. While the BEA

occasionally adjusts its definition—software was included in 1999—any other spending is counted as consumption.

As a result, what is called investment plays a key role in determining measured savings. Consider a family deciding whether to spend \$30,000 on a new rec room or to put young Jackie through college for a year. Since that new wing counts as investment, not consumption, will show up as \$30,000 in personal savings. Young Jackie's education? Well, that's defined as consumption, so it would reduce savings by the same amount.



An innovation and education-driven economy will fuel growth, keep asset values rising, and provide good returns for foreign investors.

True, a low official savings rate does require borrowing from overseas to fund consumption and investment. And this dependence, in turn, increases the vulnerability of a country if foreign investors should decide to pull out.

Still, as global capital markets become more efficient, generating internal savings is less relevant. Money flows easily across borders and searches out the highest return, which is why the U.S. has been able to easily finance its budget deficit. Moreover, appreciated assets can be sold on global markets and turned into cash.

In addition, conventional savings is like a commodity. When a European or Japanese family puts money in the bank, their euros or yen end up in the global savings pool, mixed with funds from other countries—there's no competitive advantage.

Spending on education and R&D offers a stronger foundation for solid long-term growth.

COLLEGE FUND The U.S. spends 2.7% of GDP on higher education

is more informative to look at what might be called the "golden savings rate"—the share of GDP devoted to education and R&D. By that measure, the U.S. far outperforms its major industrialized rivals. According to the latest data, the U.S. devotes 9.6% of its GDP to education and R&D. The next closest countries are France and Canada, at 7.8% and 7.5%, respectively, followed by Germany and Japan.

Rising Asset Prices

WHILE OTHER COUNTRIES chide the U.S. for being profligate, Americans are putting more money into the things that matter over the long run. That's reflected in U.S. economic performance, among the strongest in the world. Both in the short run—the past year—and the long run—the past 20 years—the U.S. has had the fastest growth of the major industrialized countries.

Moreover, low personal savings has not stopped Americans from accumulating plenty of assets for retirement. Strong economic growth has lifted both housing and equity values. Over the past decade, for example, the S&P 500 is up 182% and Standard & Poor's 500-stock index is up 158%, far more than the London, Frankfurt, Paris, or Tokyo stock exchanges. Over the same stretch, the average household net worth is up 67%, adjusting for inflation and subtracting federal debt.

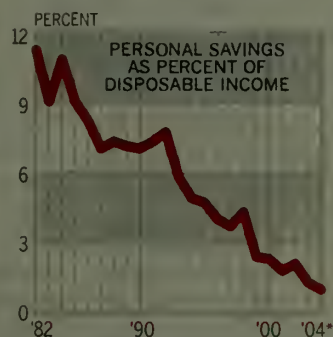
So the goal is to boost productivity, innovation, and growth, and government policy should emphasize spending on education and R&D, not tax measures that discourage savings. That would go a long way toward addressing concerns that the quality of U.S. education, especially at the K-12 level, is slipping compared with that of global rivals.

Having a large pool of college-educated workers is crucial for competing globally, for example, especially in innovative industries. According to a new report from the Organization for Economic Cooperation & Development, the U.S. spent 2.7% of GDP on higher education in 2001, while countries such as France, Germany, and Japan—with far higher official savings rates—spent only 1% or so of their GDP on higher ed. These countries have a much lower percentage of college grads in their labor force than the U.S., one reason why it was harder for them to take advantage of the Information Revolution. Overall, the U.S. spends 7.3% of GDP on education at all levels, the highest among the major industrialized nations. The lowest is Japan, which spends only 4.6% of GDP on education.

There are some signs that economists are looking beyond conventional measures of savings and investment. A recent paper by two researchers at the Bureau of Economic Analysis acknowledges that the national income accounts "do not treat R&D as investment and thus underestimate R&D's contribution to national savings, the country's stock of knowledge, and the economy as a whole." And Edward C. Prescott, the 2004 winner

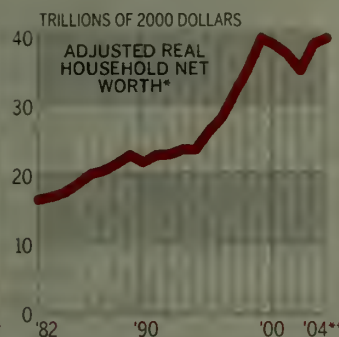
NOT AS BAD AS IT SEEMS

Americans don't save the way they used to...



Data: Bureau of Economic Analysis, Federal Reserve

...but their wealth is near a record high...



**THIRD QUARTER

...and they spend a bigger share of GDP on R&D and education

U.S.	9.6%
France	7.8%
Canada	7.5%
Germany	7.4%
Japan	7.3%
Britain	7.0%
Italy	6.0%

*Source: Bureau of Economic Analysis
Data: U.S. Bureau of Economic Analysis

of the Nobel Prize in Economics, along with Ellen R. McGrattan of the Federal Reserve Bank of Minneapolis, argue that ignoring "corporate intangible investments" such as R&D gives a distorted picture.

But a fascination with savings still permeates Washington. In recent years, the lack of savings has been used to justify such diverse measures as the Bush Administration's dividend tax cut, and new forms of tax-deferred accounts, such as the Roth IRA. The Democrats, for their part, want to roll back Bush's tax cuts to reduce the budget deficit and increase national savings.

The coming debates over tax reform and private accounts for

Social Security are going to be framed in terms of the rate as well. All the proposals for overhauling the tax system geared toward putting more of the weight of taxation on consumption, and less on savings and investment. And many supporters of Social Security privatization claim that the system lowers savings, because Americans rely on the system to fund their retirements rather than putting money away themselves.

In the end, what will propel growth is human capital innovation. It's the hidden savings rate that deserves attention, not the official one. ■

RETAIL BANKING

TAPPING A MARKET THAT IS HOT, HOT, HOT

Wealth is soaring among fast-growing Hispanics—yet 56% have no bank accounts

WHEN NATIONAL City Corp. bank decided to roll out 78 new branches in Chicago two years ago, it went in knowing its market. With Hispanics expected to account for virtually all of the city's population growth over the next decade, the bank hired dozens of Spanish-speaking staffers and printed thousands of glossy pamphlets, hawking savings accounts to new immigrants and explaining the benefits of IRAs to more established Latinos. This year, the nation's 10th-largest bank will double its Hispanic marketing budget, targeting middle-class Latinos with direct mail offering mortgage financing and money-market accounts, all written *en español*. "A simple hello in Spanish," says Christian Sandoval, vice-president of Hispanic marketing at National City, "can open the door to a Hispanic better than a product with a 4.5% interest rate."

From Bank of America Corp. to Banco Popular, tapping into the growing Hispanic market is increasingly

key for U.S. financial institutions. Indeed, U.S. banks may soon go on a shopping spree in search of smaller regional players with ties to Latino communities. They'd better hurry: Foreign banks such as Spain's Banco Bilbao Vizcaya Argentaria have already snapped up banks in Texas, California, and Florida. Now, predicts Jack M. W. Phelps, senior financial analyst for the Federal Deposit Insurance Corp., "we'll see domestic banks buying small Hispanic-oriented banks to acquire their skills."

TRUCKING TELLERS

BY NOW, THE GROWING economic clout of the Hispanic community is well-known. So what's driving the banking push? For starters, it's the fact that relatively few Latinos have any kind of banking accounts. Fully 56% of the nation's 40 million Hispanics have never held a bank account, according to market researcher Simmons Inc.

That's a rich vein for banks to tap. With Hispanics' wealth and population rising three times faster than the U.S. average, the FDIC predicts that they will



NEW YORK Banks big and small are reshaping their marketing

account for more than 50% of U.S. banking growth over the next decade, amounts to more

\$200 billion in new business, since retail banking revenues are projected to increase 44%, to \$963 billion over the next decade, according to Economy.com.

Those numbers have banks big and small rapidly reshaping their marketing to get in on the boom. In California, Wells Fargo & Co. is redecorating branches with Mexican themes to help spur holders of *matricula consular*, the Mexican ID cards often used by immigrants, to open 700 new accounts per day last year. At Bank of America, Spanish-language advertising brought in 1 million new checking accounts for Hispanics last year—fully 25% of new accounts opened. And Banco Popular, a fast-growing bank based in Puerto Rico, now sends trucks that are outfitted with teller booths to U.S. construction sites so Latino laborers can deposit checks directly into banking accounts. Wherever Latinos live and work, the numbers are not far behind. ■

—By Brian Grow in New York

U.S banks may start snapping up regional players with Latino ties

ENTERTAINMENT

YOUR FAVORITE TV SHOW IS CALLING

With quality video cell phones on the way, media companies are thinking small

FOX'S THRILLER 24 IS ALREADY a major TV hit in the U.S. and across much of Europe. And now a scaled-down version of the show is coming to an even smaller screen—the one on your cell phone. Later this month, Fox Broadcasting Co. will roll out one-minute “mobisodes”—mobile episodes, get it?—of 24 on Europe's Vodafone Group PLC network. And starting in February, Verizon Communications' U.S. subscribers may be able to get mobisodes of the show on their cell phones, too. If 24 becomes a wireless hit, the media giant will follow up with other programming, including reality shows.

Fox has plenty of company. With viewers increasingly abandoning TV for the Internet and video games, studios, and other media companies are rushing to jump into the growing market for cellular video. Just the last month the likes of Warner Bros., and ESPN have signed deals to bring everything from sports highlights to comic books to super-small screens.

With an estimated 170 million cell phone users out there, it's a potentially huge market. Industry analyst Stat/MDR figures the cell phone market will generate just \$32.7 billion this year, but that could jump to \$100 billion by 2008. The question is, will Americans want downsized video—and if so, can companies make money on it? The business model is far from clear,”

John Burris, director of Wireless Data Services for Sprint Corp. “But this is a real business; a lot of content players want in.” Cellular providers and media giants are trying to duplicate the success of video services overseas. Cell phone users

in Japan and Korea already can watch TV on their handsets, and Vodafone offers sports highlights in Europe. Such services have been limited so far in the U.S. because the rollout of high-speed cellular networks has lagged behind other countries. Even



Coming Soon to A Phone Near You

FOX is creating one-minute “mobisodes” based on its hit drama 24 for Vodafone and Verizon

WARNER BROS. will offer cell phone users behind-the-scenes videos of teen drama *The OC*

ESPN aims to beam sports clips and news shows to a branded ESPN phone on Sprint's network

MARVEL COMICS has a deal with mobile game maker MFORMA to create comics and other content

24 ON VERIZON
The cell version will have different actors

change this year. New third-generation phones running on beefed-up digital networks will hit the market during the first quarter. Cellular providers say they'll be capable of delivering near cable-quality video.

now, the TV shows offered by 14-month-old California startup MobiTV are jerky at best.

All that could

With the technological pieces finally falling into place, entertainment companies are scrambling to come up with programming. Warner Bros. aims to put *Looney Tunes* on some phones, as well as behind-the-scenes clips of its teen soap *The OC*. MTV Networks is negotiating with Microsoft Corp. to stream rock videos on AudioVox Corp. and other phones. And Verizon is expected to announce deals with several media companies, say industry insiders.

LOTS OF CLOSE-UPS

SUCCESS, OF COURSE, will require content that people actually want to watch on their cell phones. Analysts expect one- to three-minute video bursts to catch on initially—what Sprint's Burris calls “snack TV.” The studios also have to tweak their content for those minuscule screens. In shooting its cellular version of 24, for example, Fox featured more close-ups. At the outset, shows will be tailored to sports and news junkies and the younger viewers who live on their cell phones—and are the advertising sweet spot for TV execs.

How will companies make money? Subscriptions could be one way. MobiTV has signed up roughly 100,000 customers who pay \$10 a month for more than 20 cable channels. Verizon and Fox won't reveal the per-mobisode price for 24. But Warner expects to charge as much as \$5.99 for each snippet of *The OC Insider*; it will also offer the show as part of a \$24.99 yearly subscription to a fan club. Others plan to sell ads. Mobliss, a Seattle marketing firm that also makes original programs, is working with Nike Inc. and Coca-Cola Co. to cram product placements into its shows.

Another wrinkle: With TV rights to most shows still held by broadcasters rather than the media outfits that produce them, producers are being forced to come up with duplicate programs. The cell phone version of 24, for example, will feature a new cast that doesn't include star

Kiefer Sutherland.

With so much up in the air, some players are hanging back. “We're not sure it's a real business yet,” says Sony Pictures Entertainment Chairman Michael Lynton, whose company is focusing instead on Internet downloads of its soaps. “But we're watching closely to see how Fox does with 24.” With 170 million super-small screens out there, he'd be foolish not to. ■

—By Ronald Grover in Los Angeles



AUTOS

MITSUBISHI: FALLING FURTHER BEHIND

New models face fierce rivals, and a fuzzy brand image makes them a tough sell

IT'S TOUGH BEING THE SAVIOR OF a company that may be beyond salvation. Just ask Finbarr J. O'Neill, the auto executive who turned around Hyundai Motor Co.'s U.S. business. Sixteen months ago, O'Neill was picked to work similar magic at Mitsubishi Motors Corp.'s North American unit. He started quickly, scrapping the easy financing terms that created big credit problems for Mitsubishi, putting the brakes on the bulk sales to rental car companies that reduced resale values, and eliminating the youth-oriented TV ads that looked more like music videos than car commercials.

Unfortunately, while the moves may have been necessary, they accelerated Mitsubishi's slide. U.S. sales fell 37% in 2004, to 161,000 cars and trucks, the worst performance of a major auto maker. And on Jan. 3, O'Neill, 52, abruptly quit and took the helm of Reynolds & Reynolds Co., which provides software and services to car dealers.

Mitsubishi soon announced a new CEO, Rich Gilligan, its well-respected head of U.S. manufacturing. But he is widely seen as a placeholder until the parent names a permanent U.S. chief. And with sales sliding, the brand eroding, and a dearth of sure-fire models, it is increasingly unclear that anyone can save the U.S. unit. "It's tough to market Mitsubishi," says O'Neill's predecessor, Pierre Gagnon. "They're stuck between the high-quality image of Toyota and Honda and the value of the Korean brands."

Mitsubishi had hoped O'Neill would do for it what he did for Hyundai. During his five years as Hyundai's U.S. CEO, O'Neill persuaded his Korean bosses to get serious about quality and bring out the Santa Fe, a popular SUV designed for the U.S. market. To build confidence in the brand, O'Neill introduced a 10-year power-train warranty. Sales tripled during his tenure, to 350,000 units a year.

O'Neill's efforts to engineer a similar feat at Mitsubishi didn't

pan out. Last year he introduced the "Best backed cars in the world" extended warranties and free maintenance. But where Hyundai's quality proved, Mitsubishi's problems continued.

That, and a confused brand image, hampered O'Neill's efforts to lure more upscale buyers. In the late '90s, Mitsubishi had gone after the youth market, using deep discounts as bait. It wound up attracting lots of lower-income buyers who defaulted on

EX-CEO O'NEILL His efforts to do what he had done for Hyundai fizzled



loans. So O'Neill began targeting middle-class families. He was hoping for a redesign of the Galant sedan would bring them in. The problem was the car. According to Automotive Marketing Consultants Inc., it brake-checked better and accelerated faster than the Honda Accord and Toyota Camry. But that wasn't enough to get buyers to budge from those better-known brands. O'Neill acknowledged the benefits were "not successfully communicated" to buyers and says he'd consider switching ad agencies.

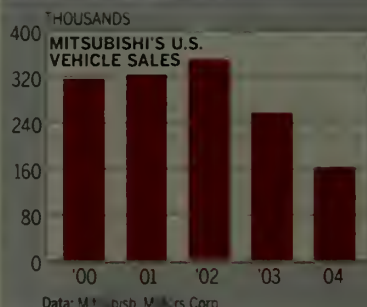
WHY THE CEO BAILED

IT DIDN'T HELP that practically from the moment O'Neill took over, there was turmoil at the top. Six months after he joined the company, DaimlerChrysler, having allocated \$3.5 billion into Mitsubishi, balked at putting in more. Not long after that, Mitsubishi Group put together a \$4.7 billion bailout, displacing Daimler as the majority shareholder. Suddenly, O'Neill, who had seen Mitsubishi as a stepping stone to a job at DaimlerChrysler, was now dealing with Japanese bosses who were pushing for faster results. It wasn't long, O'Neill says, before he was considering his options.

Can Mitsubishi claw its way back into the industry with too many players? It's a tough bet. But two new models this month—North American International Auto Show in Detroit: a redesigned Eclipse sports car and a pickup called the Raider, part designed in Southern California. But the segments are crowded. And without new models or the marketing to set them apart, Mitsubishi's troubles are only likely to get worse. ■

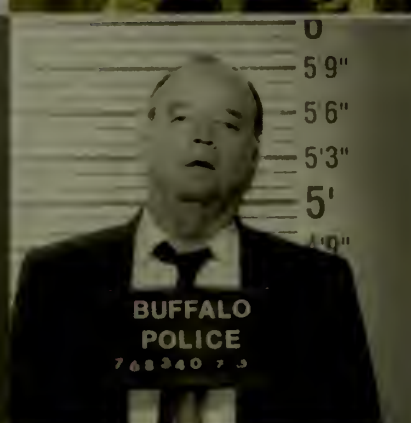
—By Christopher Palmieri
Los Angeles, with Chester Dawson in Tokyo, and David Kiley in New York

LOSING TRACTION



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EDITED BY MONICA GAGNIER

HEADLINER

GERALD GRINSTEIN



SLASHER IN THE SKY

In a move dreaded by some rival airline executives, Delta Air Lines CEO Gerald Grinstein announced plans on Jan. 5 to simplify domestic fares. The strategy, which others will likely match, is expected to slice revenues in an industry struggling to turn a profit. Investors drove down airline shares in the wake of Delta's decision.

The new fares are an effort to entice customers who have long loathed the complex rules and high last-minute ticket prices of the major airlines. While Delta's \$499 cap on one-way economy prices is still higher than many discount fares, the new SimpliFares could slow the market share gains of such rivals as Southwest, JetBlue, and AirTran. The changes could cut industry revenues by 4% or up to \$3 billion a year, figures analyst Michael Linenberg of Merrill Lynch. Grinstein figures Delta will gain share and stimulate new traffic. But even if the plan doesn't generate extra revenue, he is bowing to the realities of a market driven by discounters.

—Wendy Zellner

PRESCRIPTION FOR GROWTH?

These days, everyone in Big Pharma seems to be taking it on the chin because of problems with prescription drugs. So what's Bristol-Myers Squibb's response? It wants to put even more emphasis on such patented medicines. Although Bristol won't comment, published reports say the New York-based company is close to selling its over-the-counter medicine unit, which makes Excedrin and Bufferin pain pills. Consumer-drug sales have been flat at roughly \$350 million, or less than 2% of Bristol's total revenues of \$21 billion. Still, analysts say the unit could fetch \$700 million. Bristol could use the money to find new prescription drugs. It recently lost patent protection on diabetes drug Glucophage, sending sales tumbling, while its cholesterol-lowering Pravachol is losing market share to newer drugs.

A JUMP START AT GM



General Motors is already stoking incentives to start the new year, adding \$1,500 rebates for repeat buyers. It's no wonder. Although auto makers sold cars and trucks at a record annualized rate of 18.4 million in December, GM was the only major

company to suffer a dip in volume. GM's sales slid 6% in the month, and its market share for the year fell to 27.2%, from 28% last year. Even rival Ford Motor, which has typically struggled to boost sales, managed a 1% gain in December. If overall sales cool off in the first quarter after the strong December, expect GM to remain aggressive.

TERMINATING PUBLIC FUNDS

California Governor Arnold Schwarzenegger will support a legislator's initiative to privatize the state's pension plans, including the California Public Employees' Retirement System, the nation's largest, at \$180 billion. The proposal would put state employees hired after July, 2007, into privately managed accounts similar to 401(k) plans and is designed to cut state expenditures on retirement benefits. The measure is opposed by unions who say it would put retirement savings at risk and make it harder for the state to recruit talented employees.

KREMED AGAIN

The holes in Krispy Kreme's accounting keep growing larger: On Jan. 4, the Winston Salem (N.C.)-based doughnut chain said it will restate earnings for the fiscal year ended February, 2004, reducing previously reported net income by as much as 8.6%. The restatement—which the company warned may not be the last, as the Securities & Exchange Commission and a special audit committee continue to pore through its books—results from certain operating expenses that

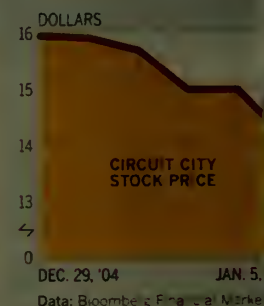
Krispy Kreme previously rolled into the cost of buying back some franchising agreements. At the same time, the doughnut chain said it will restate its fourth-quarter financial reporting, which the SEC will put it in default on its main \$150 million credit facility as of Jan. 5, though it's hoping to receive a waiver from lenders.

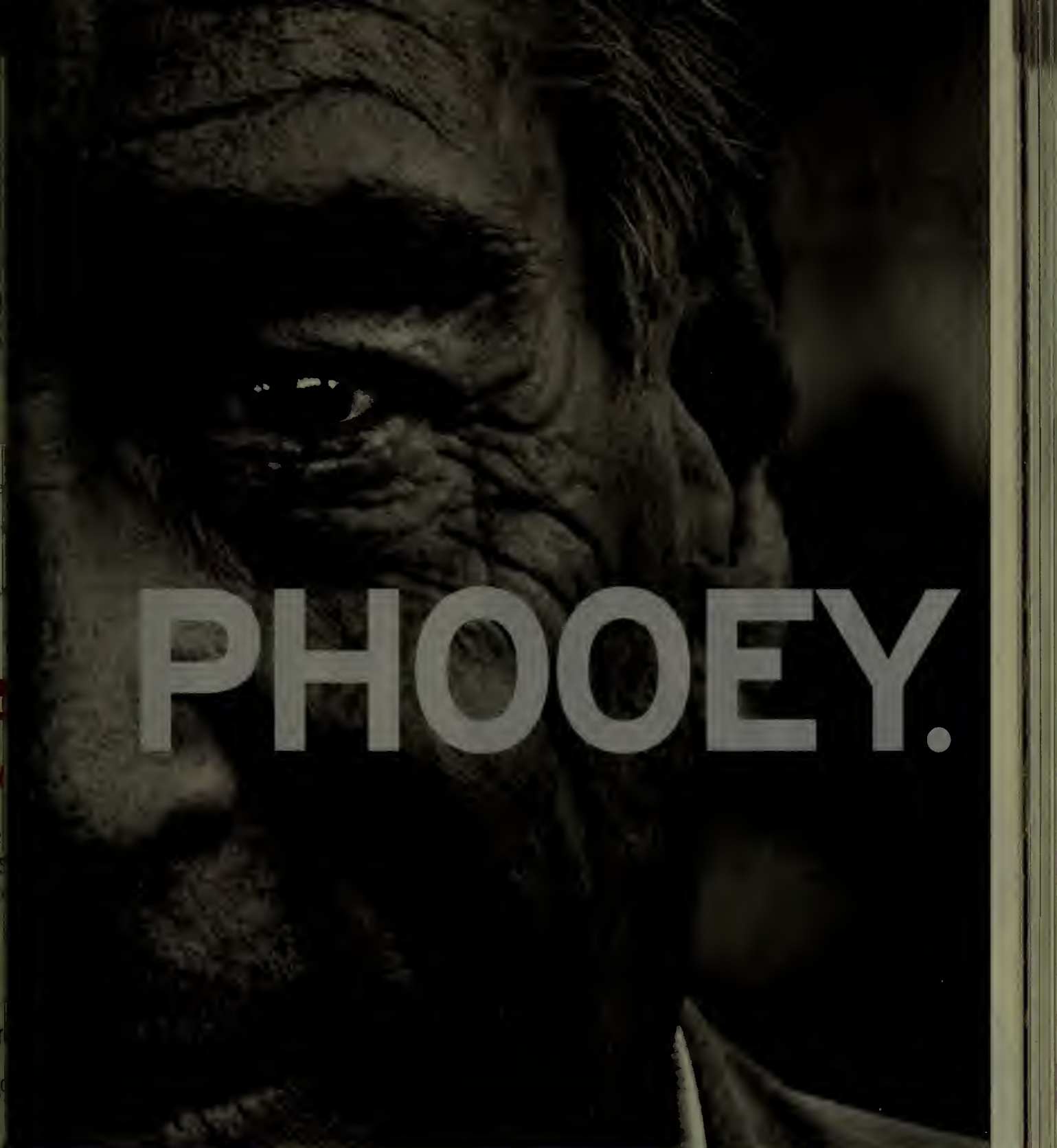
ET CETERA...

- » Nordstrom's December sales rose 9.3%.
- » Chipmaker Xilinx reduced its revenue estimate for December.
- » Sirius Satellite Radio will offer up to three video channels in partnership with Microsoft.

CLOSING BELLS

No. 2 electronics retailer Circuit City Stores blamed rivals' aggressive promotions for its lackluster year-end. On Jan. 5, the company said December sales grew just 1.8%, while sales at stores open a year or more slipped 5.8%. Shares fell 8.4%, to \$13.71, on the new





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Extending Life

Science For A Better Life



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The New Bayer: CropScience MaterialScience HealthCare

EDITED BY LEE WALCZAK

Where Have All the GOP Reformers Gone?

ONE END OF PENNSYLVANIA Avenue, President Bush persuaded his father and former President Bill Clinton—not exactly a mutual admiration society—to join hands by leading a U.S. drive to raise millions for South Asia's tsunami victims. The publicity push continued on Jan. 3 when George W. urged fresh-

members of the 109th Congress to get together to “take on the big issues.” That message obviously didn't travel to the other end of the avenue. There, House Republicans flirted with political disaster contemplating controversial rule changes designed to shield embattled Majority Leader Tom DeLay. While cooler heads eventually prevailed, on Jan. 4 House Republicans rammed through revisions that give the GOP a virtual veto on internal ethics investigations—and permit lawmakers to negotiate for jobs with special interests even as they write legislation that benefits the same group. “An absolute outrage,” wailed House Minority Leader Nancy Pelosi (Calif.).

Shielding Filibusters

DISCONNECT between the high-toned White House and the historic and down-and-dirty Capitol Hill politics poses a major challenge to the President's ambitious second-term agenda. Bush wants sweeping changes in Social Security, health-care financing and taxes—all of which require at least a modicum of across-the-aisle cooperation. Since Republicans still lack a veto-proof majority in the Senate, Democratic votes are vital to head off opposition filibusters. Increasingly, my-way-or-the-highway Republicans are focusing on tactical priorities that heighten partisan tensions—complicate Bush's strategy for giving the reform agenda a bipartisan sheen. The tonal dissonance is heightened by controversies swirling around DeLay. The close DeLay associates have been indicted by an Austin grand jury probing

campaign fund-raising, and House Republicans are desperate to protect their No. 2 leader from what they consider a political vendetta by a Democratic prosecutor. But their first solution—repealing a rule that requires an indicted leader to temporarily step aside—subjected the GOP to widespread ridicule. Representative Christopher Shays (R-Conn.), for one, reminded colleagues that the GOP won the House in '94 by campaigning against Democratic excesses and promising “a higher standard.”

Shays's comments point up the role reversal on Capitol Hill in the decade of GOP rule. Republicans have backtracked on term limits, central to their “Contract With America.” They have engaged in verbal acrobatics to justify record budget deficits. They have expanded the pork-barrel spending they condemned under Democratic dominance. And they have twisted the rules to marginalize the minority.

What has been lost? Any sense that the GOP will clean up Congress after decades of Democratic abuses. “That's the history of reform movements,” says Brookings Institution senior fellow Stephen Hess. “Before the blink of an eye, the reformist who took over the banana republic is acting just like the people he deposed.”

Tinhorn authoritarianism may temporarily tighten the conservative firebrands' grip on power. But it limits GOP growth potential with reform-minded independents—the kind of voter that Bush managed to corral. And without public support for his ambitious agenda, the President could fall short in his quest to become a reformer with results. ■

—By Richard S. Dunham



DeLay: An embarrassing scheme to shield him was withdrawn

CAPITAL WRAPUP

RICE'S STRATEGY FOR REMAKING STATE

SECRETARY OF State-designate **Condoleezza Rice** has been spending time at Foggy Bottom interviewing employees to get a feel for the place—and identify possible high-level appointments. Rather than fundamentally reshaping the State Dept. bureaucracy, insiders think she will elevate some career Foreign Service officers sympathetic to the Bush Administration's hard-line worldview. Such a move allows Rice to place careerists in high positions—as outgoing Secretary **Colin L. Powell** did—thus fostering staff loyalty while putting ideological soulmates in key slots.

Another sign of a hawkish second term: the expected departure of the moderate **Brent Scowcroft** as chairman of the Foreign Intelligence Advisory Board. Scowcroft served as national security adviser to the President's father and was a vocal critic of the war in Iraq.

CBO CHIEF WARNS: TIME TO CHOOSE

OPTIMISTIC congressional Republicans have downplayed the seriousness of record federal deficits. Their reasoning: A period of sustained economic growth and productivity gains will reduce, if not completely erase, red ink without deep budget cuts. Not so, says **Douglas Holtz-Eakin**, director of the nonpartisan Congressional Budget Office: “Productivity does not solve this problem, and you don't grow your way out of it. This is about budget choices.” Of course, the U.S. grew its way out of huge deficits in the nineties. But Holtz-Eakin argues that exploding Social Security and Medicare costs as a result of coming baby boomer retirements preclude a repeat of that feat.

CHINA

LET THE RETAIL WARS BEGIN

Newly unfettered foreign chains could grab more of China's market

ON A COLD AND WINDY Friday afternoon, Li Fang is rushing to get some shopping done before the weekend begins. And the 30-year-old human resources manager knows exactly where she wants to go: the Carrefour hypermarket, a 10-minute bus ride from her apartment in north Beijing. It's not the cheapest option, but the French-owned store has all the meat, vegetables, and fruit she needs. "Carrefour offers high quality and a better variety of products compared to other supermarkets," she says.

Many more Chinese will soon get a chance to sample the quality and variety at Carrefour and other foreign-owned stores. In keeping with the conditions for China's membership in the World Trade Organization, Beijing on Dec. 11 lifted most restrictions on foreign retailers. Gone are limits on the number of stores, rules confining them to large cities, and regulations capping the foreigners' stake in local ventures at 65%.

China erected those hurdles to give its own companies a chance to copy the West's big-store model—and they have done so with great success. The top four retailers in the country are all run by the government or local entrepreneurs, led by a rapidly expanding chain called Shanghai Bailian. But the foreign companies are nipping at the locals' heels, and they have big plans for expansion now that the barriers have been torn down.

Paris-based Carrefour has some 240 stores in China, and plans to open as many as 150 more this year. Its 2003 sales of \$1.8 billion make it China's fifth-biggest retailer. China "is very important for our future," says Jean-Luc Chéreau, executive manager of Carrefour China.

PREMIUM ON CONVENIENCE

CARREFOUR WAS quick to get into China and often pushed the regulatory envelope, bypassing Beijing and cutting deals with local governments. Although that strategy got Carrefour into hot water at the time, the company has emerged as the undisputed leader. It has even bested its Bentonville (Ark.) rival, Wal-Mart Stores Inc., which has 43 stores in 20 Chinese cities, and another 10 in the works this year. Germany's Metro is the No. 3 foreign player, with 24 stores and another 40 within five years. All told, dozens of foreign companies have opened in the mainland.

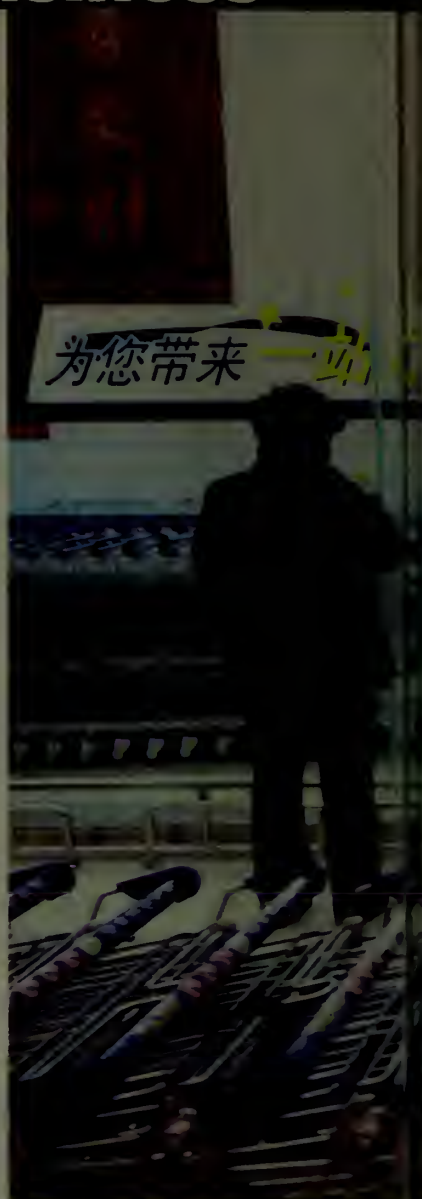
Moving In

In December, China relaxed restrictions on foreign retailers, including limits on the location of stores. Here are the biggest domestic and foreign players

CHINA			FOREIGN		
STORE	2003 SALES*	RANK AMONG RETAILERS IN CHINA	STORE	2003 SALES*	RANK AMONG RETAILERS IN CHINA
Shanghai Bailian	\$5,860	1	Carrefour	\$1,623	5
Dalian Dashang	2,196	2	Wal-Mart	707	16
Gome	2,149	3	Metro	679	18

* Millions of dollars

Data: Commerce Ministry of China



Why the rush? Over the past 20 years, retail sales in China have jumped 15% annually, to some \$628 billion in 2004—making it the third-largest market on earth. And consumer expectations have shot up even faster. Just a few years ago most Chinese were content to shop up in state-owned stores to buy what

was available, then shifted to unsanitary outdoor markets for meat, and vegetables. Now, both local chains and the multinationals are pushing out the old state retailers by building big, convenient stores in central locations in Beijing, Shanghai, Guangzhou. With the end of geographical restrictions, the battle



BIGGER IS BETTER

Stores like Wal-Mart are hot

boasts nearly 5,000 stores and 2003 sales of \$5.86 billion, has won per-

mission to take over four rivals. And CRE in December boosted its stake in China's 10th-largest retailer, Suguo Supermarket, to 85%. Beijing's ultimate goal is to create a dozen or so big local players that will be strong enough to compete with the multinationals at home and expand overseas. "China's market should be mainly dominated by Chinese retailers," says Huang Guoxiong, a professor of economics at People's University in Beijing. "It is not possible to allow foreign retailers to take the dominant position."

NERVOUS OFFICIALS

THERE'S LITTLE DOUBT that Chinese retailers and government officials are getting nervous about the growing foreign competition. Vice-Premier Wu Yi—Beijing's tough trade negotiator—last year met with the heads of top retail companies to discuss strategy. Under Wu's guidance, the Commerce Ministry is considering guidelines that would require cities to provide detailed blueprints for all retail expansion plans. Some fear that measure could be used to brake the foreigners' advance.

Ultimately, the clash between locals and foreigners may be tempered by realities on the ground. While the locals need managerial talent, financing, and greater scale, the foreigners need help navigating China's vast retail market—and even

more so as they move beyond the large coastal cities. That means that in spite of the newly relaxed rules on ownership, Wal-Mart, for one, will continue to work through joint ventures. "Our partners are knowledgeable about the business in China, and we learn from them," says Wal-Mart spokesman Bill Wertz. And foreign retailers that decide to go it alone may soon find them-

selves facing many of the same problems the locals have—fickle customers with little brand loyalty and challenges hiring decent staff. Shopper Li's sole complaint about Carrefour: "I can never find employees when I need them." The stores, local or foreign, that get such issues right are the ones that will win the battle for the wallets of China's consumers. ■

—By Dexter Roberts in Beijing,
with Wendy Zellner in Dallas and
Carol Matlack in Paris

Big Chinese retailers—often backed by Beijing—are fighting the invaders

finance will shift to smaller cities. The customers are a middle class that totals at least 100 million. These shoppers like to buy clothes, TVs, and groceries at clean, modern outlets with a full range of products on hand. Surveys show the top factors Chinese consider in deciding where to shop these days are convenience, followed by the spaciousness and comfort of stores and the selection they offer. Price ranks only sixth, according to researcher ACNielsen. Shopper Li would concur. One of the best features of the two-story Carrefour: It's easy to find what she's looking for. "The layout is perfect," she says.

With the foreigners attacking their turf, Chinese retailers are fighting back. Take China Resources Enterprise, which operates more than 1,700 supermarkets and hypermarkets, including China Resources Vanguard stores. The retailer has trimmed its staff to boost profitability, and has sought to improve management by raiding the foreign

chains. Today nearly half of the middle and senior managers in CRE's retail unit have worked at foreign-owned stores. Those foreign-trained managers have brought in marketing expertise. For instance, to build brand loyalty CRE rewards frequent shoppers with discounts, and the company has rolled out more than 60 private-label products, including bottled water, shampoo, and body lotion. And CRE is moving upscale. The company this year expects to open four "lifestyle" stores offering higher-quality products. Plans call for an additional 20 such stores within three years. "We are targeting middle-class people with money," says Jonathan Wang, chief operating officer of China Resources Vanguard.

There's consolidation sweeping the sector, too. Shanghai Bailian, which



MEDICINE

WANTED: NEW WEAPONS AGAINST AN OLD KILLER

Malaria may surge after the tsunami—but stronger new drugs are still a ways off

FLY OVER COASTAL AREAS around the Indian Ocean, and you'll see the destruction wrought by the tsunamis that swept the region in December. Houses have been reduced to heaps of rubble, cars and boats sit atop seawalls and jetties, and everything is soaked, with murky, brackish water pooling in gardens, fields, and forests.

For survivors, that stagnant water poses a threat that will surely compound the suffering. Soon it will become a breeding ground for mosquitoes that carry malaria. "All you need is for water to sit in a hot environment for a few days, and you'll see an increase in malaria," says Laurie Garrett, senior fellow for global health at the Council on Foreign Relations in New York. Yusuf Hamied, managing director at Indian drugmaker Cipla Ltd., even sees the possibility of a widespread outbreak.

Malaria is already one of the world's most virulent killers. The disease causes as many as 500 million acute illnesses and kills 1.5 million people each year.

Worse, the parasites that cause malaria have built up resistance to the drugs commonly used to treat it, chloroquine and mefloquine. Often the only alternatives are low-tech, such as mosquito nets treated with insecticide. "They're easy to make," says Han Heijnen, a World Health Organization adviser in New Delhi. "You just have to leave the net in the solution for half an hour."

Where are the new medicines on the market to fight this scourge—especially at this critical moment? Unfortunately, malaria research has for decades been hobbled by the fact that the disease no longer affects the affluent parts of the world. So few companies have paid much attention. Aid donors won't be rushing huge quantities of new malaria medicines to help tsunami victims.

But there is hope of a

IN SRI LANKA
The stagnant waters carry another threat

breakthrough new drugs in the offing. A decade now, scientists have

working to perfect anti-malaria treatments based on a traditional Chinese medicine created from the artemisia wormwood, plant. Once ingested, the plant's extract, artemisinin, is converted into a free radical that can destroy the vital processes of the parasite. Used with other drugs, artemisinin has proven effective against resistant malaria strains. The natural drug, however, is in short supply, can lack potency, and sometimes creates neurological side effects, so researchers have been working to develop synthetic versions.

PRO BONO

MUCH OF THE PROGRESS in malaria research can be credited to the Bill & Melinda Gates Foundation, which is funding research on AIDS and other diseases. Since 2000 the foundation has given almost \$250 million for malaria research. "Before, people had ideas but no money to do them," says J. Carl Acle, chief scientific officer at Geneva-based and Gates-funded Medicines for Malaria Venture (MMV).

There's also a newfound willingness in Big Pharma to act on a pro bono basis to combat the disease. Since 2003, Swiss drugmaker Ranbaxy Laboratories Ltd. has been working on an anti-malaria drug that was once a project of Hoffmann-La Roche Group. The Swiss company concluded it could not make the drug profitably, so it handed it to MMV, which then partnered with Ranbaxy. "This reinforces the commitment we have toward developing intellectual property," says Malvinder Singh, Ranbaxy's executive director.

Swiss giant Novartis, which has developed Coartem, the first widely available, sells the compound at cost—though it is still expensive and in short supply.

Many of the new medicines are in early stages of development. But with tsunamis hitting countries receiving billions in aid—and malaria posing a threat to the recovery—may finally be both the impetus and the means to tackle one of the world's most dangerous diseases. ■

—By Bruce Einhorn
Hong Kong, with Malvinder Singh
Kripalani in Boston



1.5
MILLION

Annual deaths from malaria

Data: Institute for OneWorldHealth



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REPORTER'S NOTEBOOK

HOW INDIA IS SPRINGING INTO ACTION

In Tamil Nadu, the relief effort is intense, fast-moving—and surprisingly efficient

To see firsthand the effect of the tsunami on India's southeast coast, Bombay bureau chief Manjeet Kripalani traveled to the state of Tamil Nadu. She saw great devastation—but also signs of a tremendous will to rebuild. Her report follows.

AFTER HEARING so many stories of bureaucratic bungling and the slow pace of the tsunami relief effort, I was surprised to find the East Coast Road south of Madras crowded with trucks carrying grain, water, tents, and clothing. India's record in such catastrophes is dismal: The country has been hit by eight natural calamities since 1989 and has rarely been able to get food, water, and shelter efficiently to the victims. But this time, in the district of Cuddalore, authorities sprang into action, quickly providing relief to local fishermen and their families. In at least this small corner of India, the local administration took the steps necessary to care for those in need.

One key to the effort is Gagandeep Singh Bedi. He is Cuddalore's "district collector," the most powerful local official in India's administrative system. The 36-year-old civil servant learned about the tsunami the hard way: He was having breakfast at a waterfront restaurant when the waves struck. He managed to get himself and his family to high ground and sped back to his office. Within two hours he had mobilized the police, hospitals, doctors, the phone company, and the state transport authority. Four hours later, Bedi had called a meeting of community leaders and asked individuals and nongovernment



REACHING OUT
India's record in disasters has been poor

organizations to pool their resources with those of government agencies.

That translated into quick relief for people in places such as the island of Sonakuppam. Just two miles from Cuddalore and, until a bridge was built last summer, accessible only by boat, Sonakuppam was a relatively prosperous fishing village of 2,500. Many of its bright pink, green, and blue brick houses sported TV sets, and the average annual income topped \$1,000—twice the national level. Villagers owned nearly a hundred \$2,000 fiberglass catamarans, motorized tugboats, and 30-foot wooden steamboats. Every day the men went to sea, bringing back fish for the women to take to market in Cuddalore. Many village children even attended school—a sure sign of prosperity. The tsunami brought an end to that good life. Most houses and

virtually all the boats were destroyed by the wave's fury, and 53 villagers are dead, half of them children. Only the bridge and the Hindu temple, built on raised ground, remain untouched. They're where residents took refuge from the water.

Thanks to Bedi, the inhabitants of Sonakuppam aren't being ignored. He ensured that by imposing no restrictions on groups that want to deliver aid. A truck from the federal government is unloading rice, lentils, blankets, and tents. A small army contingent from the Madras Regiment is clearing debris. The Communist Party is delivering blankets. The former mayor of Madras brought food. UNICEF has trucked toys for the children, and a Buddhist monk is trying to soothe 28 Buddhist monks and Scientologists from Great Britain and Australia has pulled up troops for trauma relief.

REBUILDING LIVES

IT WOULD BE HARD to say that the villagers are happy, but they're not complaining. They're grateful for the charity and are setting about rebuilding their lives. The children are playing, the women do their chores in the rubble, and the men are busy trying to dole out relief packages. When the trucks roll in or to pull out the wrecked power poles and put in new ones.

That's the easy part. Now they have to reconstruct their homes. Bedi would like to see strict enforcement of zoning rules—which would keep many from rebuilding too close to the beach, where the old houses were. And the villagers

need to repair their boats or buy new ones so they can start earning a living again. The government has promised help, but Bedi laments that India can't build enough vessels to fill the need. "We should import boats—fast," he says.

The tsunami has been a tragedy for India, but it's an opportunity, too. The country may rethink its archaic village planning and create communities with proper sanitation and other infrastructure. "The villagers start life afresh, better than they were living before," says B. K. Joshi, chairman of Srinivasan Sarva Trust, a private foundation. Another tsunami may spur India to institutionalize disaster management, so its people can respond efficiently to future tragedies—rather than relying just on good will and hard work of the local community. Cuddalore's Gagandeep Singh Bedi

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COMMENTARY

BY JOHN ROSSANT

Can the U.S. and Europe Make Up?

As relations heal, along comes the thorny issue of weapons sales to China

ONLY 18 MONTHS ago, White House National Security Adviser Condoleezza Rice had a terse, no-nonsense formula for dealing with key opponents of American policy in Iraq: Punish France, ignore Germany, forgive Russia. Today, though, the message from the Bush Administration is all sweetness and light: The U.S. and Europe

need to patch up their differences.

That's the big reason the White House has chosen Europe for Bush's first post-inaugural foreign foray in late February. "We're reaching out to Europe, and we hope Europe will reach out to us," Secretary of State Colin L. Powell said in a December speech in Brussels. The U.S. and Europe are finding common ground in a number of areas, from restructuring NATO to crafting the latest Middle East peace initiative. "There are a lot of indications that the Europeans are being more sympathetic," notes Ezra Suleiman, European political specialist at Princeton University.

But there's one big issue that could yet mar this picture of rapprochement. It's not Iraq, or transatlantic trade spats like the one between Airbus and Boeing Co. It's China. France, and to a lesser extent Germany, have stepped up efforts to persuade other European Union members to lift a blanket embargo on weapons sales to China by the summer. The U.S., which maintains its own embargo, is staunchly opposed to such a move.

Both bans were imposed in the wake of the Tiananmen Square crackdown in 1989. Washington's official line is that China's human rights record has not improved sufficiently to warrant removal of the ban. Yet what really troubles Washington is the prospect of European weapons being used against U.S. armed forces should they have to defend Taiwan. "There's something very offensive about the notion that American soldiers might be killed by weapons produced by allies and sold to China over our objections," says Kenneth G. Lieberthal, a top Asia hand in the Clinton Administration who's now at the

Brookings Institution in Washington. There's no imminent danger of a war, even if China now says Taiwan is its primary security threat. But China is building a ring of offensive missiles on its side of the strait, and is interested in purchasing sophisticated components and systems from European suppliers.

Why would Europe persist in ending an arms embargo on China just when it's trying to mend relations with the U.S.? Europeans say the current policy unreasonably lumps China with rogue states like Burma, Sudan, and Zimbabwe—the only other targets of EU arms embargoes. And the Chinese are insisting that stepped-up business with European companies, such as aerospace giant EADS, could depend on lifting the embargo.

NATO sources say that U.S. officials pleaded with the Europeans not to lift the ban in the runup to a December EU summit.

To no avail. Now some U.S. policymakers and foreign-policy analysts are simmering. "It strikes me as the most outrageously provocative move," says Walter Russell Mead, senior fellow at the Council of Foreign Relations in New York.

A confrontation over this issue would have plenty of unforeseen consequences. The European Council, the Pentagon has made a number of threats that U.S.-EU military technology cooperation is at risk if the embargo is lifted, EADS cannot export any U.S. deals for its transport planes or other armaments.

Is there a way out? Talks are under way to find a compromise. "Having a serious discussion about weapons sales to China is smarter than telling Europe they would be severely punished if the embargo was lifted," says François Heisbourg, an adviser to the French government. One possibility would be to allow Europe to sell weapons that don't pose a specific threat to the kind of global networked electronics and data systems the U.S. would deploy.

A showdown over Taiwan. Constructing a common approach to China as a strategic power would be the surest sign yet that U.S.-European relations are improving. Failure to compromise could yet ruin the détente that is just being rebuilt.

—With Stan Crock in Washington



A THAW?
Bush and Chirac

Europe may lift its arms embargo. The U.S. is staunchly opposed

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EDITED BY ROSE BRADY

The Party of the Future in Britain?

ACTION FEVER IS RISING in Britain. Just about everyone assumes that Prime Minister Tony Blair will call for a national vote this spring, probably on May 5 to coincide with already scheduled local elections. Yet many think the player to watch in the campaign will be neither Blair, whose third straight win looks likely, nor

Conservative boss Michael Howard. Instead, pollsters and voters are focusing on a politician largely unknown outside Britain—Charles Kennedy, leader of the third-party Liberal Democrats.

Kennedy won't knock out Blair, but he will make things uncomfortable for Howard. Since assuming the top party post in 1999, Kennedy has put the Liberal Democrats in their strongest position ever, with 55 seats in the House of Commons vs. 163 for Labour and 163 for the Conservatives. The Lib Dems look likely to gain from 40 to 40 more seats in May, says Andrew Cooper, managing director of pollster Populus. "The simple story is a decisive shift to the Lib Dems," Cooper says.

Self-Destruction?

THE RISE OF the Lib Dems could rattle the landscape of British politics. If this slight-of-center, pro-European party does well, while the Tories improve only modestly and Labour lose ground, then Kennedy's troops would be in a position to challenge the Conservatives as the main opposition party in future elections. Cooper says such a result would mean the "internationalization of more of a three-party system than we are used to."

The Conservatives would be the big loser in the short term. In fact, some analysts think the Tories could be on a path to self-destruction. Peter Kellner, chairman of YouGov, sees the possibility of a bridgeable gulf opening between Tories who are basically moderate and pro-European in outlook and those who are more nationalistic, right-wing, and anti-European. Just as the Social Democrats broke

away from an unelectable Labour in the 1980s, so these Tory moderates could leave their party, perhaps joining the Lib Dems.

Kennedy, 45, is pursuing what analysts call a "decapitation" strategy against key Tories. Pollsters give the Lib Dems a good shot at toppling Shadow Chancellor of the Exchequer Oliver Letwin, Shadow Home Secretary David Davis, and former Tory Chairman Theresa May, who all squeaked by in 2001 with narrow majorities. Even Howard could fall to a Lib Dem surge.

Kennedy's party has made greater inroads in Tory areas such as Southwest England than in Labour strongholds such as the Midlands. The Lib Dems appeal to well-educated professionals and women, voters the Tories would like in their camp. But recently the Lib Dems snatched two Labour seats in by-elections in constituencies with big Muslim populations. Kennedy's opposition to British involvement in the Iraq war was key. He has also gained support with his stand against Labour's

higher university tuition fees. And he opposes Blair's push to require all Britons to carry identity cards. On the economic front, the Lib Dems are the only party that clearly favors joining the European single currency.

Chris Rennard, the Lib Dem chief executive, says the party's goal is "to gain enough seats from both Labour and the Conservatives to demonstrate that we are a more effective opposition than the Conservatives and to show we are eventually a more likely alternative government to Labour." A long shot? Perhaps. But Kennedy is shrewd and young enough to be a player for many more years. ■

—By Stanley Reed in London



KENNEDY The Lib Dems are poised to gain seats

GLOBAL WRAPUP

THE SEC TARGETS A MEXICAN TYCOON

SAYING THAT "geographic boundaries will not serve to protect those who seek to defraud investors," the U.S. Securities & Exchange Commission on Jan. 4 filed civil charges against **TV Azteca**, Mexico's No. 2 broadcaster, and three top executives and directors of the company. The SEC alleges that Chairman **Ricardo Salinas Pliego**, 49, violated provisions of the Sarbanes-Oxley Act by carrying out a secret debt transaction for the company's telecom unit, Unefon, that earned him a personal profit of \$109 million. Salinas, who rejected several SEC offers to settle the charges, called the allegations "false, in bad faith, and discriminatory." The SEC is seeking to bar Salinas and two other directors from serving as executives or on the board of any company that trades publicly in the U.S. The shares of TV Azteca trade in the U.S. as American depositary receipts.

TURKEY AND ISRAEL PATCH IT UP

TURKEY AND Israel are trying to mend relations strained by Turkish Prime Minister **Recep Tayyip Erdogan's** sharp criticism of Israeli actions in the Palestinian territories. Turkish Foreign Minister **Abdullah Gul** visited Israel in early January, and Erdogan is expected to follow later this year. Turkey and Israel have long cooperated on security, but the ties have cooled since Erdogan's Islamic-tinged Justice & Development Party took power in 2002. Even so, trade between the two countries topped \$2 billion last year, up 40% from 2003. As a gesture to Turkey, Israel announced the end of its ban on investments in the Turkish part of Cyprus.

COMMENTARY

BY RONALD GROVER

Sumner Redstone's CEO Sweepstakes

He has his two top talents racing against each other to fix Viacom's problems

NOBODY EVER doubted that octogenarian Chief Executive Sumner M. Redstone could put on a good show. By the time Viacom Inc. President Mel Karmazin finally took a powder in June, Redstone was well aware of the jitters on the Street about his succession plans—or lack of them. So he pulled off a masterstroke, naming his longtime confidant and

MTV Networks guru Tom Freston and his CBS prime-time ratings magician Leslie Moonves as dueling lieutenants. In the realm of CEO succession plans, the bake-off has all the makings of Hollywood high drama.

At least that's how it seems to have been scripted for investors. But with Redstone, things may be trickier than they appear. Sure, "[he] knew people were nervous because there wasn't a succession plan, so he gave them one," says analyst Jake Balzer at Guzman & Co. "We'll see if he keeps it." But Redstone is cleverly getting more. Rather than announce one heir, he's setting up his top two talents to go into hyperdrive and take the risks needed in today's high-stakes media world. It's a way to hold on to both guys and get investors jazzed again. How could the Tom and Les Show fail to eventually give his stock a kick, especially after dropping 14% since last January?

Until now, most observers assumed that the CEO gig was Freston's for the taking, even if it meant waiting years for Redstone to call it quits—or for that other inevitability that would create a vacancy in the corner office. After all, it was Freston, then a go-getter at MTV, who met secretly with Redstone as the Boston theater chain mogul was plotting a hostile run to take over Viacom back in 1987. That sealed a bond between the two that only grew with MTV's repeated successes over the years.

But Moonves, the gravelly-voiced onetime actor who earned his red-hot status by reviving a tarnished Tiffany Network with cool programming such as *CSI*, is showing that he might just make a race of it. A hands-on guy

who has been known to pick the actors himself for Moonves got out of the gate first. Charged with turning around Viacom's Infinity Broadcasting, he sold a small radio station, tends to sell more, and told analysts that he would focus the company on its "oceanfront" properties in the 20 largest markets. Still, with radio ad sales up a minuscule 2% last year, only modest gains expected again in 2005, Moonves has not quickly to find revenues in the hot Hispanic market. He swapped Infinity's San Francisco station for a 10% stake in the fast-growing Spanish Broadcasting System Inc., with a first option on the rest, as well as inking a marketing agreement that CBS' ad team to sell time for the Spanish stations, too.

Freston isn't coasting, either, despite his front-runner status. He hopes to turn around Paramount Pictures Corp., which has been plagued most recently by such bombs as the *The Stepfather* and *Alfie*. He put his MTV research team in charge of the studio and politely eased longtime studio chief Sherry Lansing.

Heir to the **Viacom** Throne

The media giant's two co-presidents are both in the running to succeed Chairman Redstone—someday



TOM FRESTON

AGE: 59

BACKGROUND: A former ad exec who started in a low-ring position with MTV in 1980, he gets credit for his vision to expand the MTV brand, as well as create channels such as VH1 and most recently Spike TV.

CHALLENGES: Overhaul bomb-laden Paramount Studios (hiring Brad Grey as the new chief would be a start). He also needs to upgrade original programming on also-ran pay channel Showtime to compete with HBO.



LESLIE MOONVES

AGE: 54

BACKGROUND: A onetime actor known for having the "golden gut" for creating hits *ER* and *Friends* at Warner Bros.' TV unit. Now he wins kudos at CBS for turning around the network's prime time with such shows as *Survivor* and *CSI: Crime Scene Investigation*.

CHALLENGES: Boost Viacom's ailing Infinity radio unit by selling underperforming stations, and building alliances with fast-growing Hispanic-language Spanish-language radio.

Data: BusinessWeek, Viacom, Merrill Lynch

o retirement. Since then, he has chat-
up big-time names to head the studio,
cluding Universal film chief Stacy
der. Most recently, he has been nego-
ing with talent manager Brad Grey,
o produces *The Sopranos* for HBO but
a film neophyte. Freston figures Grey's
unctions would lure talent that has
ered clear of Paramount's penny-
ching ways. Seeking a younger audi-
e for Paramount, Freston also signed
iversal Music Group hitmaking exec
my Iovine and Eminem's manager
il Rosenberg to make films for the stu-
. No Viacom exec would comment.

Mousetrap?

AT'S A LOT OF positive energy at a
npany that was distracted for years by
orted clashes between Redstone and
mazin. Now, Redstone gets to enjoy a
able benefit: His two deputies race
h other to fix problems, and Moonves,
ought-after manager these days, re-
ins in the fold. Remember that just a
months ago, when things weren't
king so good for CEO Michael D. Eis-
at Walt Disney Co. across town,
oonves' name landed on the list of po-
tial Mouse House successors. Sensing
t a winner might slip away, Redstone
ckly promoted him.

But Redstone is nothing if not unpre-
table, as he has proven in the past by
ning out potential successor Frank
ndi and alienating Karmazin. Red-
ne even has a booby trap of sorts wait-
for Freston and Moonves, each of
om signed contracts to receive \$15
lion a year in salary, bonus, and de-
ed compensation. But the contracts
o give Redstone the opportunity to
ne the men co-CEOs by 2007, effec-
ly keeping the chairman's job for him-
or his 50-year-old daughter Shari,
o runs the family-owned National
usements Inc. theater chain. "So what
anges then?" asks Biondi. "You still
ve two guys working hard to please the
guy, and the top guy is Sumner or his
ughter. That's succession?" True to
lstone form.

Moonves himself appears to be clear-
d about the role he has been chosen to
y. His intimates say he has let it be
own that even now he wouldn't shun
rtures from the Disney board, which is
ected to name Eisner's successor
netime later this year. The odd twist:
e guy who gave *America Survivor*
uld vote himself off the Viacom island.
d that could abruptly foil Redstone's
ewd two-for-one play. ■

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Morgan Stanley: No Stars —And Lots of Top Tech IPOs

The firm has perfected the long-term team approach to landing high-quality clients that are ready to go public

ON THE MORNING OF Apr. 5, 1996, Morgan Stanley's head of investment banking, Terry Meguid, walked into the firm's Silicon Valley office and was greeted by the sight of empty desks. He had flown in from New York the night before, just hours after Frank Quattrone, the firm's head of tech banking, had called to say he was joining rival Deutsche Morgan Grenfell and was taking about 25 employees with him. It was a huge blow: Since the early 1980s, Quattrone had built Morgan Stanley's tech banking practice from a backwater into a powerhouse.

Over the following months, Meguid doggedly rebuilt the firm's tech practice around a handful of remaining employees and new recruits. And this time he vowed to do things differently: He made sure power wasn't concentrated in one person—or in one location. The episode “gave us an opportunity to step back and say: ‘What’s the best way to build this business so we never feel [it] is so dependent on an individual that it’s unhealthy?’” he says.

Last year showed how well that strategy can work. While Quattrone was appealing an 18-month prison sentence for obstructing an investigation of Credit Suisse First Boston, which he joined after leaving Deutsche, Morgan Stanley's tech team had a remarkable 2004. It raised \$4.6 billion from initial public offerings of tech stocks worldwide, according to researcher Thomson Financial. That performance put Morgan Stanley at the top of the rankings for tech IPOs, after finishing fourth in 2002 and 2003. The highlight: managing the \$1.7 billion offering of search engine Google Inc.

That an institution and not an in-

dividual grabbed the spotlight last year shows how much tech banking has changed. A long bear market and four years of scandal and reform have forced bankers to sober up. Also, tech banking has matured over the past decade from a niche dominated by charismatic salesmen into a global game played by highly orchestrated teams. “The business today isn’t about any one person,” Meguid says. “It’s about the brand and the franchise.”

Morgan Stanley wasn’t the only brand that did well last year. Goldman Sachs Group Inc., the 2003 king of tech IPOs, finished second, raising \$3.8 billion in high-profile offerings

VETERANS Grimes, Stewart, Chamberlain, and Cory have all been with the firm for 10 years or more

for Freescale Semiconductor Inc., San Interactive Entertainment Ltd., and other companies. And both Goldman and CS outranked Morgan Stanley in the value of tech mergers and acquisitions they advised worldwide in 2004, says Thomson.

Yet Morgan Stanley stood out for the quality of its tech IPOs. Ultimately, the



king group is judged not by the value of deals in one year but by repeat business with successful companies over many years. Tech bankers compete most fiercely for the IPOs of companies thought to have the best chances for long-term growth. Such outfits do follow-on offerings and acquisitions, providing their bankers with fees for years.

ANALYSTS STILL MATTER

THIS YEAR, MORGAN STANLEY managed to score an outsized portion of the hotly contested tech deals. In a June 13, 2004, article, "IPOs-in-Waiting," *BusinessWeek* named the four most sought-after tech IPO candidates for 2004: Google, customer-management software maker Salesforce.com, chipmaker Atheros Communications, and business-infrastructure software maker VMware. Morgan Stanley had IPOs for Google, Salesforce.com, and Atheros, and advised VMware on its \$635 million sale to EMC Corp.

Morgan Stanley's bankers can't take all the credit for winning the plum deals. In an age of reform on Wall Street,

research analysts still matter when companies select banks to take them public. Analysts can no longer accompany bankers calling on clients or prospects. But companies still meet with analysts separately, and those meetings influence their choice of a bank.

In the case of Google, Morgan Stanley's Internet analyst, Mary Meeker, met with the company in between visits from bankers long before its IPO. "Mary Meeker's sponsorship was of significance," says Michael Moritz, a venture capitalist at Sequoia Capital and a board member at Google. "She knows the company well." Meeker also called on 51job.com. "The banking side can't promise anything from the analyst side," says David Chao, a venture capitalist at DCM-Doll Capital Management and a board member at 51job.com. "But it definitely was one factor in our decision even though in this new world, theoretically, it shouldn't matter."

Morgan Stanley has been laying the groundwork for its big year for some time.

After Quattrone's departure,

Morgan Stanley added tech bankers not only in the U.S. but also in Europe and Asia, and focused on getting them to work as a team. Like its peers, the firm began pruning back its tech practice in 2000 and had laid off about 60% of the staff by 2003. But instead of exiting some foreign markets, as a

Even during the slump, Morgan kept calling on startups and VCs

Smash Hits

Morgan Stanley's recent tech IPOs have soared

STOCK-PRICE GAIN*

GOOGLE

Internet search engine

128%

RIGHT NOW TECHNOLOGIES

Provider of online customer-management software

129%

51JOB.COM

Chinese online recruitment site

243%

SALESFORCE.COM

Provider of online customer-management software

64%

* From IPO date through Jan. 1, 2004
Data: Bloomberg Financial Markets

few rivals did, it maintained a lean version of its worldwide organization. "We saw that the business would continue to become more global," says Dhiren Shah, global head of the technology group at Morgan Stanley.

The decision paid off. In 2004 banks found themselves vying for the IPOs of several Asian companies. "Every bank wanted to participate in a transaction involving 51job.com," says Paul E. Chamberlain, a managing director at Morgan Stanley. The Shanghai-based site is China's biggest jobs listing, and its profitability and growth are exploding. It wound up choosing Morgan Stanley to lead its \$73.5 million offering. "We wanted a firm that was strong on both sides of the Pacific," says Chao.

Morgan Stanley also made important moves at home during the downturn. From 2001 to 2003, its bankers called on clients, startups, and venture capitalists even while the IPO and M&A markets were dormant. "Of all the groups, Morgan Stanley has worked the hardest to stay engaged in the venture community," says Charles Beeler, a venture capitalist at

El Dorado Ventures in Menlo Park, Calif. At tech's low point in 2001, Morgan Stanley launched the CTO Summit, an annual conference that introduces startups to the firm's chief technology officer and info-tech staff.

LONG-TERM RELATIONSHIPS

BY STAYING CLOSE to clients, the firm was first in line to provide advice when software companies began a series of mergers in 2003. "We did the first wave of software consolidation," says Chuck Cory, Morgan's head of tech M&A. That year, the firm advised software maker J.D. Edwards on its \$1.7 billion sale to PeopleSoft, which inspired a hostile bid for PeopleSoft by Oracle. "J.D. Edwards had a long history with Morgan Stanley," says Robert Dutkowsky, the former CEO of J.D. Edwards. "It was a relationship of trust."

Long-standing relationships were vital to winning IPOs, too. Despite the loss of personnel during the downturn, Morgan Stanley's tech group prides itself on the



continuity of its remaining members. Several people—including Shah, Chamberlain, Cory, technology capital markets head Colin Stewart, and Managing Director Michael D. Grimes—have been with the firm for 10 years or longer. “That’s really important to clients—not moving around, not moving to the next European bank that’s trying to overcompensate someone,” Grimes says.

HOT RIVALRY

THE CONTINUITY at Morgan Stanley helped it win the Google deal. Grimes’s relationship with the company began in 1999 and lasted through the rise, fall, and recovery of investors’ appetite for Internet stocks. “This was not a piece of business that was won in the last 90 days,” says Google board member Moritz. In the case of salesforce.com, lack of continuity may have cost one of Morgan Stanley’s competitors the IPO business. “We would have loved to have used Goldman Sachs, but Paul Phillips, the tech-banking head, left just as we were starting our selection process,” says

Marc Benioff, CEO of salesforce.com.

Goldman Sachs could have the last laugh if it regains the top spot in tech IPOs this year. Morgan Stanley “can be beaten, there’s no question,” says Tor Braham, co-head of tech M&A at Deutsche Bank Securities Inc., which

edged out Morgan Stanley last year to lead the IPO of business software maker Unica Corp. Universal banks such as Deutsche Bank, Citigroup, and UBS, which also offer commercial banking, have made headway in tech IPOs and M&A in the past five years. That has put added pressure on pure investment banks such as Morgan Stanley and Goldman Sachs.

If 2005 turns out to be anything like 2004, Morgan Stanley will give its long-time rival fits. Already, the firm plans to lead a public offering that’s likely to be one of the year’s hottest—digital audio developer Dolby Laboratories Inc.’s (Goldman Sachs will co-manage the deal). Not bad for a tech investment banking team without a star. ■

—By Justin Hibbard in San Mateo, Calif.

E*Trade Rises From the Ashes

The online broker is back in the black—thanks to its ultradisciplined CEO

MITCHELL H. CAPLAN insists he never doubted that E*Trade Financial Corp. would survive. Not when shares of the online broker and bank plunged from more than \$60 at the peak of the Internet frenzy to below \$3 in 2002. Not even when the outfit lost a total of \$428 million in 2001 and 2002. “I felt great about the business model,” says the 47-year-old lawyer-turned-entrepreneur who rose to chief executive two years ago and was charged with getting the company on track. “I knew that if we stuck with it, we would get our story out.”

Caplan’s optimism has paid off. While E*Trade was given up for dead after the dot-com bust, its prospects now look bright. The nation’s third-largest online broker just wrapped up its second profitable year in a row, earning an estimated \$376 million on \$1.52 billion of revenue. The company also told Wall Street that earnings could come in above \$400 million this year on as much as \$1.8 billion in revenues. Investors have bid E*Trade’s stock up to \$14 a share. “They survived the bubble, and they’ve come out the other end much stronger,” says Friedman, Billings, Ramsey Group Inc. analyst Matthew J. Snowling.

Sure, the stock market rebound has helped, but much of the credit goes to the buttoned-down Caplan. Confronted with a culture that ignored red ink as long as the stock price climbed, he quickly went to work cutting costs and focusing the business. E*Trade no longer splurges on \$2 million Super Bowl commercials. Instead of the \$500 million a year it once spent on marketing—more than the entire U.S. liquor industry

spends on ads—it will lay out a mere \$140 million this year. Caplan also dispensed with distracting sidelines: a national ATM network, kiosks in Target stores, a palatial New York retail boutique that sold E*Trade souvenirs, and a business-news service. New ventures such as a string of small storefront offices in major cities, are rigorously vetted for profitability. “I am adamant—a whole team we are all adamant—about financial returns,” he says.

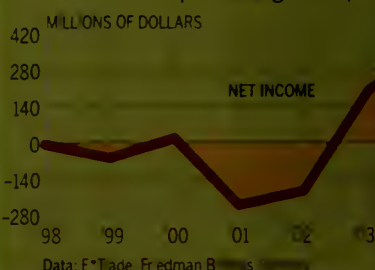
RUBBER CHICKENS

SYMBOLIC MEASURES may have been as important in instilling discipline in the ranks. Breaking with E*Trade’s past, Caplan moved the headquarters from Menlo Park, Calif., to New York City. Left behind were the prop beanies and rubber chickens, gaudy props that kept the atmosphere light. Now jackets and ties are de rigueur. There are fewer employees, too: about 4,000, down from 5,000 at the peak.

Caplan joined E*Trade just as the frenzy was ebbing in 2000. A native Virginia, he earned a law degree and an MBA from Emory University in Atlanta and practiced law in New York for

INTERNET SURVIVOR

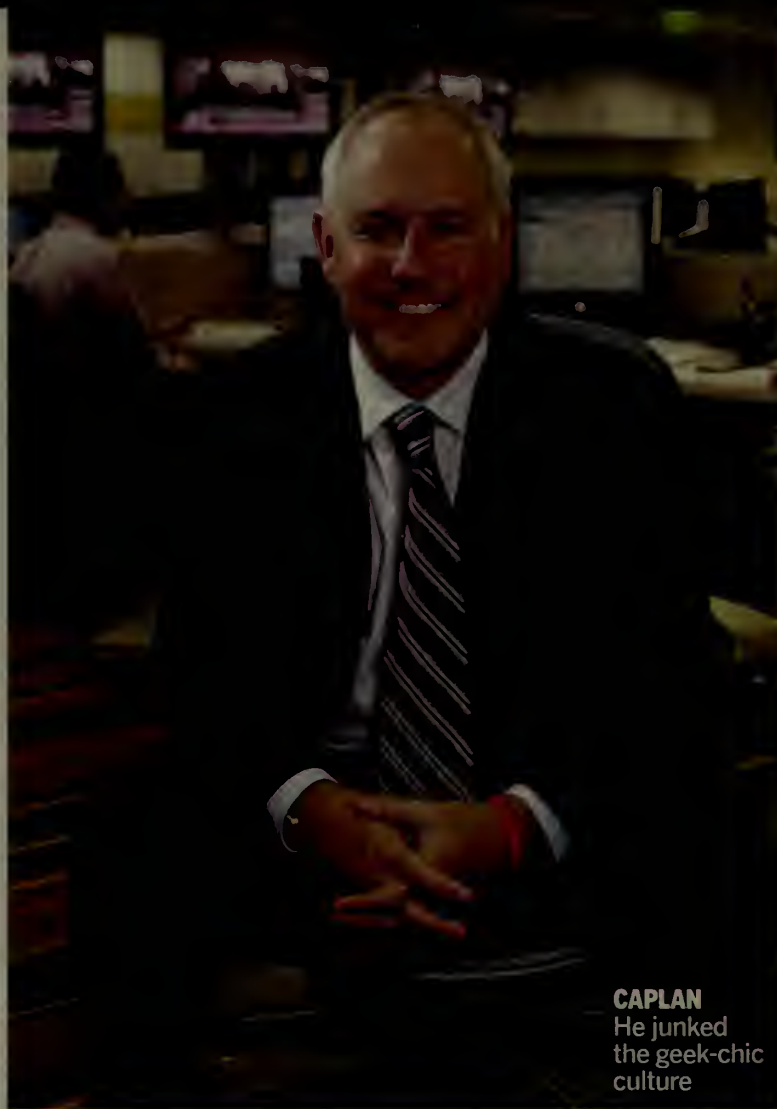
After years of losses, E*Trade is producing solid profits



s. In 1989 the entrepreneurial bug bit, and he launched a branchless savings and loan, TeleBank. He hoped customers would come by phone, mail, and Internet to get cheaper rates on loans and higher yields on deposits.

Eventually phone access and Internet access. That drew E*Trade's attention: Caplan plunked down \$1 million in stock to buy TeleBank. As Caplan integrated TeleBank into E*Trade's fast-growing brokerage operation, he focused on "boring" investments, he says, such as bonds, which brought growth in revenue and earnings and return on equity. Impressed with Caplan, E*Trade's board elected him from chief operating officer to North American head and then to president and chief operating officer.

By the time Caplan became CEO in January, 2003, the company was in free fall. The former CEO, the exuberant Christos M. Cotsakos—who once had employees stand on chairs and put corporate principles on each other—had run into criticism over his \$80 million pay package he took while the company was losing millions. Cotsakos was forced to return some \$21 million. E*Trade's stock, worth about \$26 a share when Caplan sold his bank, had shrunk to a few dollars, hitting Caplan and fellow TeleBank investors in the wallet. "I'm like a passenger on the Hindenburg," says Thomas C. Danziger, a New York City lawyer and longtime friend of Caplan's. Danziger says his investment had swelled to 10 figures only to plunge to six figures.



CAPLAN
He junked the geek-chic culture

Once in charge, Caplan and his colleagues focused on exploiting E*Trade's bank, where the company had a clear edge over rivals Charles Schwab Corp. and Ameritrade Inc. By offering banking products such as checking accounts and loans at bargain rates to trading customers, E*Trade has built the nation's eighth-largest thrift. It has become a big profit center, too, accounting for nearly 40% of revenues and 48% of profits. Overall, the company boasts some 632,000 bank accounts and 2.9 million active brokerage accounts, up from 170,000 bank accounts and 2.4 million brokerage accounts in early 2000.

BUYING A RIVAL?

AFTER STRIPPING E*Trade down to its basics, Caplan is now searching for growth. He has reorganized his management team around retail and institutional customers, hoping to appeal to hedge funds and institutional traders as well as individual investors. He's also interested in acquisitions. Last year, Caplan explored buying rival TD Waterhouse Investor Services Inc.—until he realized

New ventures are rigorously vetted for profitability

that a stock deal would give the firm's parent, Toronto-Dominion Bank, too big a stake in E*Trade. He is currently sizing up Ameritrade, whose \$5.3 billion market capitalization slightly tops E*Trade's. "We've got the infrastructure," says Caplan. "We've got our costs down. Now let's complete the creation of the franchise." For its part, the relentlessly acquisitive Ameritrade is open to deals of all sorts, its executives say. Looking at the changes Caplan has made, Ameritrade CEO Joseph H. Moglia says: "Mitch has done an excellent job."

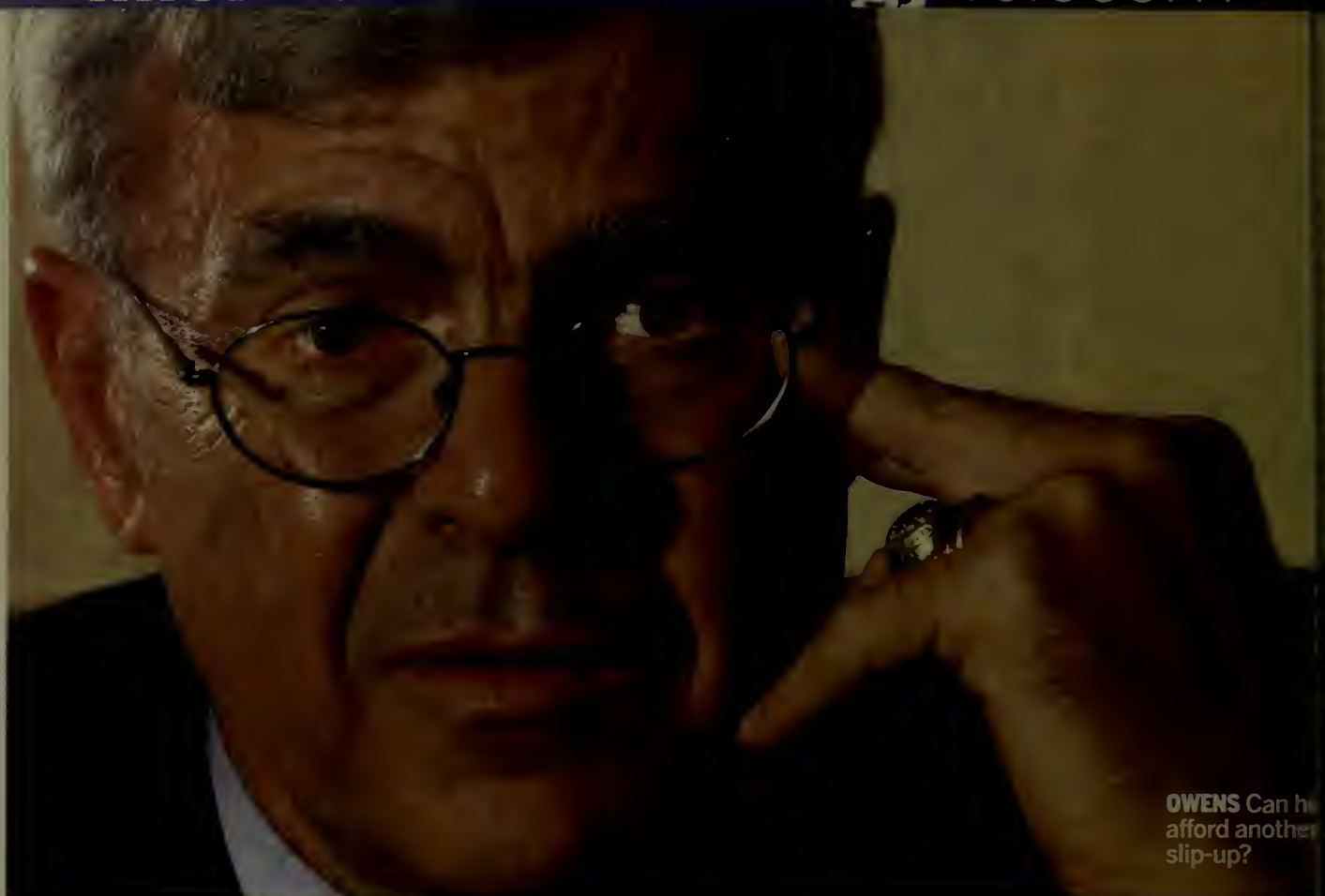
Much as Caplan's fixes have helped, he's facing tougher competition than ever. On Jan. 3, Scottrade Inc., the No. 6 online broker—and the cheapest of the major players—cut its fees. Charles R. Schwab, back in charge of his old company, is also dropping prices, although Caplan argues that Schwab is only playing catch-up.

Schwab, which recently crept ahead of Ameritrade to become the online-trading leader, is ramping up its own bank, and Ameritrade is planning to launch one, too. Schwab is "a killer company," admits Caplan, but he's confident that E*Trade's customers will stay loyal.

If it would help shareholders, Caplan says he would sell E*Trade. Still, there's little doubt he would rather come out on top. "Mitch always wants to win," says Arlen W. Gelbard, Caplan's former college roommate, now president of E*Trade's bank. Indeed, the longtime tennis buddies rarely keep score on the court anymore to keep the games from getting too competitive. But investors are keeping score—and so far, Caplan is winning. ■

—By Joseph Weber in Chicago

BusinessWeek online For a Q&A with E*Trade CEO Mitchell Caplan, go to www.businessweek.com/magazine/extra.htm



OWENS Can he afford another slip-up?

Nortel: Desperately Seeking Credibility

CEO Owens inherited a mess, but his lagging cleanup is hurting business

ONE MISSTEP, MAYBE two, shareholders could have overlooked. But on Nov. 11, William A. "Bill" Owens had to 'fess up to his third serious slip since taking over as chief executive officer at Nortel Networks Corp. last April. Just weeks earlier he had told investors that Nortel would deliver its restated financial reports to the Securities & Exchange Commission by mid-November, but at the crack of dawn on the 11th, Owens said the company would once again delay filing the documents. It was the third time in as many months that

Owens had missed a deadline he had publicly pledged to meet.

The blunder sent Nortel's shares tumbling 15%, to \$3.03, over the next 48 hours. "Owens' management pattern is pretty much inexplicable," says Duncan Stewart, a partner at Nortel shareholder Tera Capital Corp. "This kind of flip-flopping is not reassuring to shareholders." Owens said in an e-mail to *BusinessWeek* the delays have been caused by "the increasing complexity and scope of the work as it progressed."

Nortel's future may depend on whether Owens can quickly change his reputation with Wall Street. His next opportunity will come Jan. 10. That's the latest deadline for

when the Brampton (Ont.) telecom equipment maker says it will file financial statements. Even then, all Nortel is asking for that date is that it "commence to file" audited reports back to 2001.

No question, Owens inherited a Nortel rose to prominence in the late '90s by making fiber optic gear to transfer loads of data over the Internet. But subsequently hit hard when demand for Internet equipment slumped. Revenue tumbled from \$30.2 billion in 1999 to an estimated \$10 billion in 2004. Even so, for its reputation was the dismissal in 2001 of former CEO Frank Dunn, who the company said had been "terminated without cause." Now regulators in Canada and the U.S. are investigating whether he manipulated Nortel's financials to get bonuses for himself and other employees. Dunn declined to comment.

LOST BUSINESS

BUT NINE MONTHS after Owens arrived to set Canada's leading technology company back on track, it's arguably in worse shape than when he arrived. Revenue in 2004 are expected to have dropped 15% to \$10.2 billion, according to Bear, Stearns & Co. Revenues for this year are expected to climb 4%, but that's behind the 7% forecast for rival Lucent Technologies Inc.

on is largely that Nortel lags behind its
rs in selling communications gear to
porations and wireless equipment to
ne companies.

Nortel's accounting troubles are begin-
g to contribute to the revenue difficul-
as well. A month ago, Cingular Wire-
LLC announced the three suppliers for
third-generation wireless network, and
tel, long one of the company's top sup-
ers, was not among them. While many
pers were considered, Kristin S. Rinne,
ingular's chief technology officer, notes

"financial viability is some-
g you look at," Nortel con-
s its accounting issues
cost it business but says
effect is temporary.

ow, even as he strives to
plete Nortel's restatements,
ens is trying to focus the
pany on promising growth
s. Besides targeting wire-
and corporate sales, Owens
ts to tap the steady needs of
ernment. The former U.S.
y Admiral and top Defense
t, politico is betting that his
erience in Washington will
Nortel pull business from
Beltway. The company is
beefing up its resources to
ess corporate concerns
at tech security. "No one is
er prepared to do that today
a Nortel," Owens said on a
nt conference call.

t stake may be more than
ns' reputation. If he fails to
Nortel back on track or,
ven forbid, misses the Jan.
iling deadline, some ana-
think pressure will grow
the board to find a replace-
t. "Certainly his job is at
," says analyst Susan Kalla
research firm Friedman
ings Ramsey Group. Nortel
d members declined to
ment for this article.

Owens is to succeed, it will
and every bit of leadership
nen he has accumulated
the years. Owens first ar-
d at Nortel in 2002, simply
t on the board of directors.
had recently served as co-
of satellite venture
desic Satellite LLC and be-
that as chief operating offi-
of tech company Science
ications International
p. Yet it was as a military
that Owens truly distin-

guished himself. During his 34-year career
he rose to become a decorated Admiral and
concluded his tenure in 1996 as vice-chair-
man of the Joint Chiefs of Staff, the second-
ranking military officer in the country. He
developed a reputation as a bright, honest,
fair officer who could think on his feet.

After the Dunn affair, Nortel's board of
directors handed Owens the CEO job and
cast him as the company's savior. With his
baritone voice, firmly set jaw, and lofty mil-
itary résumé, he seemed the epitome of
credibility. Now he acknowledges that the

Nortel's Trail of Woe

Bill Owens was brought in last spring to
restore trust after his predecessor was
accused of accounting irregularities. But
he has repeatedly missed his own
deadlines for filing newly audited results.

APR. 28 Nortel says CEO
Frank Dunn has been
"terminated for cause"
for alleged improper
accounting practices that
resulted in bonuses for
him and other
employees. Owens is
named chief executive.

JUNE 29 Nortel says its
investigation into the
accounting issues is
progressing enough that
it expects to be able to
report audited results for
2003 and for the first and
second quarters of 2004
by September.

SEPT. 2 Nortel says it will
have to delay the release
of its financial reports
until the end of October.

OCT. 27 Nortel again says
it will miss its own
deadline for reporting
audited financial results
for 2003 and the first half
of 2004, saying the
review will not be
completed until mid-
November.

NOV. 11 Again, Nortel
says it can't complete the
restatements on time.
Owens, in a statement,
concedes that the delay
"will be disappointing to
all our stakeholders" and



adds that he expects to
complete the
restatements within 30
to 60 days.

NOV. 30 Cingular, the
country's top wireless
company, announces the
three suppliers for its
third-generation wireless
network. Nortel, long one
of Cingular's top
suppliers, doesn't get any
of the contract.

DEC. 14 Nortel
announces preliminary
financial results through
the third quarter of 2004,
showing revenue declines
and continuing losses. It
says it expects to
"commence to file"
audited financial
statements for these
periods by Jan. 10.

many delays have taken a toll on him and
his company. "It is unfortunate that the re-
statement process has taken longer than I
was originally advised it would," said
Owens via e-mail. "But it is far more im-
portant to me, Nortel Networks, and our
stakeholders that it be accurate than it be
completed on the initial schedule."

TOO TRUSTING?

WHY HAS OWENS struggled so mightily?
Three people close to him say the leader-
ship approach that served him so well in
the military may not be suited to the cor-
porate world. Owens honed his instincts in
the depths of the Mediterranean Sea as
captain of a submarine during the Persian
Gulf War. In tight quarters, with lives on
the line, he developed an approach of put-
ting almost complete faith in his subordi-
nates. "The military is based on trust,"
says Andrew F. Krepinevich, who worked
with Owens in the Defense Dept. "[Recog-
nizing that] is what helped make Bill a
success in the military."

But the associates close to Owens say
his trust in others, along with his unwa-
vering optimism, may have led to the
many missed deadlines at Nortel. When he
first arrived at Nortel, Owens refused to
give investors and analysts a firm deadline
for completing the accounting restate-
ments. But on June 29 Nortel said the in-
vestigation into the accounting issues was
progressing enough that it expected audited
results for 2003 and for the first and
second quarters of 2004 to be reported by
September. That investigation has been
supervised by the Nortel board's audit
committee, which is led by John E.
Cleghorn, former chief executive of Royal
Bank of Canada. Just two months later, on
Sept. 2, Owens had to delay the restate-
ment for the first time, until the end of Oc-
tober. "I can sense that he would put his
faith in people who said they could have
numbers by [a certain] date," says Bob
Ratliffe, a member of Owens' senior staff at
Teledesic. "When they don't deliver, he'll
stand up and take the blame."

Cleghorn did not return calls seeking
comment. Owens says that at Nortel, as in
the military, he has tried "to inspire, en-
courage, and lead" those around him.

Still, Owens' willingness to step out in
public and make optimistic pronounce-
ments strikes some analysts as poor judg-
ment. "He's the guy foolish enough to
stand up in front of rooms and say: 'It's go-
ing to happen,'" notes analyst Mark V.
Lucey of Canaccord Capital in Toronto.
Owens has no time to lose in rebuilding
Nortel's credibility—and his own. ■

—By Roger O. Crockett in Chicago



Ocean currents, temperatures are crucial elements in climate studies. Before NASA got its supercomputer, Columbia, it took a year to simulate years of changes in currents, shown in red. Now America's second-fastest supercomputer, Columbia, takes less than a day to model an entire decade—and the result has four times more detail.

Holy Screaming Teraflops

IBM's Blue Gene is the world's fastest supercomputer—for now

AFTER MORE THAN TWO years of playing second fiddle to Japan in supercomputers, the U.S. has clawed its way back to the head of the pack. A machine from IBM called Blue Gene/L, now being installed at Lawrence Livermore National Laboratory, holds the world record for supercomputing speed, scoring 92 teraflops. That's a mind-blowing 92 trillion floating-point calculations every second.

In fact, Japan has suffered a double blow. NASA's Columbia supercomputer, built by Silicon Graphics Inc., clocked 61 teraflops last fall. Both U.S. machines trumped the previous leader, the Earth Simulator from NEC Corp. With a peak speed of 41 teraflops, it had been the reigning champ since March, 2002.

As soon as Japan took the title, U.S. supercomputer users in industries such as autos, aerospace, and drugs began clamoring for still speedier machines. Better computers, they note, mean superior product designs and faster time to market. At a November supercomputing meeting in Pittsburgh, Alexander Akker-

man, a senior technical computing guru at Ford Motor Co., lamented a decade-long lack of U.S. progress in high-end computing. Ford wants beefier computers so it can run stress tests on entire engine blocks. And with its Columbia system, NASA can now predict where a hurricane will hit land five days in advance, instead of previous two-day warnings.

For the next few years, IBM's Blue Gene seems to have a lock on the No. 1 spot in the industry's premier ranking,

known as the Top500 Supercomputer Sites. This year, Big Blue expects Blue Gene to hit a screaming 360 teraflops.

SGI aims to surpass even that in raw speed. Before 2009, it plans to build a petaflops supercomputer—a machine that can chew through a quadrillion calculations every second. Cray, IBM, Sun Microsystems all aim to hit the benchmark, as part of a competition funded by the Pentagon's Defense Advanced Research Projects Agency. Petaflops computers, Detroit could use for rapid simulated crash tests of whole cars, not just fenders and bumpers.

Shorter term, the battle for No. 1 will be intense. In addition to Hewlett-Packard and the other established players, newcomers such as California's Dell, and Linux Network all plan to introduce new hardware. And Cray Inc.'s supercomputers, two Energy Dept. national labs—Sandia and Ridge—could climb to 100 teraflops and higher by around 2007.

Even Groupe Bull, France's venerable computer maker, is staging a comeback in supers. By yearend it will install a Columbia-class system for the French Nuclear Power Agency—and by 2008, the machine might grow to rival Blue Gene. Japan's NEC isn't about to let its lead slip under, either. In mid-October, the company unwrapped a new system, dubbed SX-8, that can reach speeds up to 65 teraflops.

So whatever machine is ranked No. 1, its glory days may be short. Even Blue Gene's reign could end late this decade. The only sure bet is that one-upsmanship will be good for business. As SGI's CEO, Robert R. Bishop regularly notes, "We must outcompete in the 21st century, U.S. industry must out compute." That's why the Top500 list is closely watched: It's a barometer of industrial competitiveness.

—By Otis Port in New York

The Class of '04

The world's top five supercomputers

COMPUTER/MAKER OR LAB	TOP SPEED, TERAFLIPS*	LOCATION
BlueGene/L IBM	92	U.S.
Molecular Dynamics Machine** Riken	78	Japan
Grape-6** U. Tokyo	64	Japan
Columbia SGI	61	U.S.
Earth Simulator NEC	41	Japan

*Theoretical top speed in trillions of floating-point operations per second. ** Uses proprietary chips not ranked on the latest Top500 Supercomputer Sites. Data: Riken, www.top500.org

HOW A MORE POWERFUL ENGINE HELPED FUEL ECONOMY CLIMB.

An engine with 40 more horsepower getting better gas mileage?* The Ford Expedition's new 300-horsepower, 5.4-liter, 3-valve engine is what makes it happen. This is the most powerful and most fuel-efficient 5.4-liter ever in an Expedition. The only thing more amazing is your next adventure. Visit fordvehicles.com.



EXPEDITION
Built for the road ahead.

*EPA estimated 14 city 18 hwy mpg.

The Future of The New York Times

Publisher Arthur Sulzberger Jr. has his hands full: Weaker earnings. A changing media world. A scandal's aftermath. He also has an ambitious business plan

BY ANTHONY BIANCO

S

SINCE 1896, FOUR GENERATIONS OF the Ochs-Sulzberger family have guided *The New York Times* through wars, recessions, strikes, and innumerable family crises. In 2003, though, Arthur Ochs Sulzberger Jr., the current proprietor, faced what seemed to be a publisher's ultimate test after a loosely supervised young reporter named Jayson Blair was found to have fabricated dozens of stories. The revelations sparked a newsroom rebellion that humiliated Sulzberger into firing Executive Editor Howell Raines. "My heart is breaking," Sulzberger admitted to his staff on the day he showed Raines the door.

It turns out, though, that fate was not finished with Arthur Sulzberger, who also is chairman of the newspaper's corporate parent, New York Times Co. The strife that convulsed *The New York Times's* newsroom under the tyrannical Raines has faded under the measured leadership of his successor, Bill Keller, but now its financial performance is lagging. NYT Co.'s stock is trading at about 40, down 25% from its high of 53.80 in mid-2002 and has trailed the shares of many other newspaper companies for a good year and a half. "Their numbers in this recovery are bordering on the abysmal," says Douglas Arthur, Morgan Stanley's senior publishing analyst.

Meanwhile, the once-Olympian authority of the *Times* is be-

ing eroded not only by its own journalistic screw-ups—from Blair scandal to erroneous reports of weapons of mass destruction in Iraq—but also by profound changes in communication technology and in the U.S. political climate. There are those who contend that the paper has been permanently diminished, with the rest of what now is dismissively known in some circles as "MSM," mainstream media. "The Roman Empire that mass media is breaking up, and we are entering an almost apocalyptic period where there will be many more centers of power and influence," says Orville Schell, dean of the University of California at Berkeley's journalism school. "It's a kind of disaggregation of the molecular structure of the media."

THE PRIDE THAT SULZBERGER takes in his journalistic legacy is palpable, his knowledge of the *Times's* august history encyclopedic. Yet "Young Arthur," as he is still known to some at age 57, exudes a wisecracking, live-wire vitality more typical of a founding entrepreneur than of an heir. He began an interview for this article by picking up a big hunk of metal from a conference table and brandishing it menacingly. "Ask any question you like," he growled and then deposited the object in a less conspicuous spot. "It's an award," he added softly.

Sulzberger, who succeeded his father as publisher in 1991 and as chairman in 1997, already rescued *The New York Times*



OF THE TIMES Chairman
erger (center) will now
n Robinson (left), who
placed Lewis as CEO

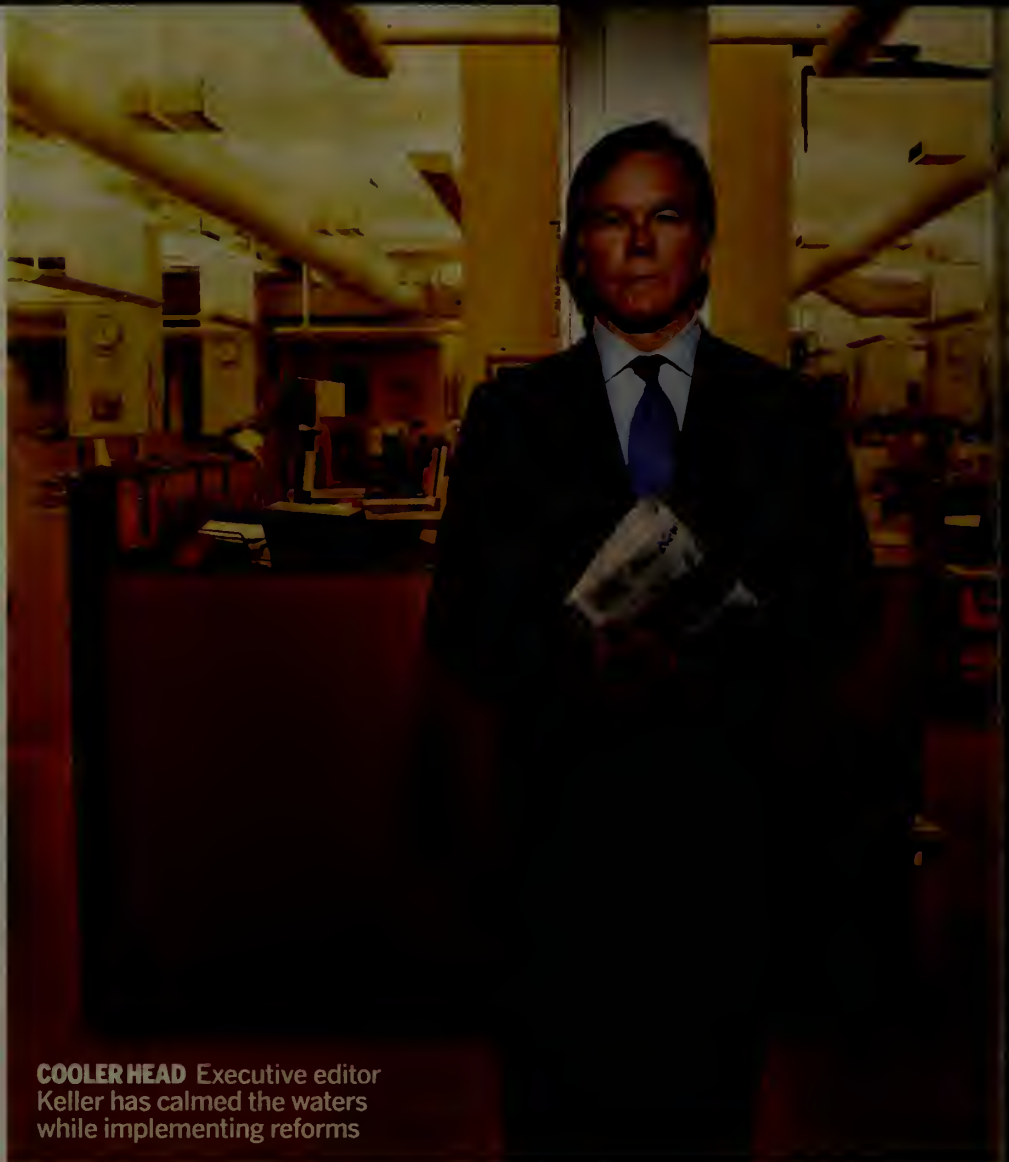
decline once. With the help of then-CEO Russell T. Lewis, he reinvented the "Gray Lady" by devising a radical solution to the threat of eroding circulation that had imperiled the *Times* and other big-city dailies for years. Sulzberger changed the paper itself by spending big money to add new sections and a profusion of color illustration. At the same time, he made the *Times* the first—and still the only—metro newspaper in America to broaden its distribution beyond its home city to encompass the entire country. Today, nearly 50% of all subscribers to the weekday *Times* live somewhere other than Gotham.

The Sulzbergers who preceded him were newspapermen; Arthur Jr., by his own description, is a "platform-agnostic" multimedia man. In the mid-1990s, NYT Co. became one of the first Old Media companies to move into cyberspace. *Times* reporters also began experimenting with adapting their newspaper stories to another medium new to them—television. Today, NYTimes.com consistently ranks among the 10 most popular Internet news sites, and New York Times Television is one of the largest independent producers of documentary programming in the U. S. "Within our lifetimes, the distribution of news and information is going to shift to broadband," Sulzberger says. "We must enter the broadband world having mastered the three key skill sets—print, Internet, and video—because that's what's going to ensure the future of this news organization in the years ahead."

Sulzberger acknowledges that he and his company are embattled in the present. "These are tough times, and they've been tough times for a while." But he and new CEO Janet L. Robinson (Lewis retired at the end of 2004) are sticking with the long-term plan set nearly a decade ago: enhancing the content of the *Times* and extending its reach into virgin territories west of the Hudson while also building its multimedia capacity. In 2002, NYT Co. added a global dimension to its growth strategy by acquiring full control of the *International Herald Tribune*, which is now being upgraded and expanded.

In essence, Sulzberger is doing what his forebears have always done: sink money into the *Times* in the belief that quality journalism pays in the long run. "The challenge is to remember that our history is to invest during tough times," he says. "And when those times turn—and they do, inevitably—we will be well-positioned for recovery."

Will it work this time? Will toughing it out Sulzberger-style revitalize the *Times* or consign it to creeping irrelevance? "Despite all that has happened, I still think that *The New York Times* has a stature and a position of journalistic authority that is



COOLER HEAD Executive editor Keller has calmed the waters while implementing reforms

greater than any news organization in the world. Could it be destroyed? I believe that it could be," says Alex S. Jones, a former *Times* media critic who is co-author of *The Trust*, a book about the Sulzbergers and their newspaper. Jones, who now heads the Joan Shorenstein Center on the Press, Politics & Public Policy at Harvard University, hastens to add that he hopes the paper will thrive again. "I tell you, I hate to think of it not succeeding," he says.

THE CONSTANCY OF THEIR COMMITMENT to high-cost journalism has put the Sulzbergers in an increasingly contrarian position. Many of the country's surviving big-city dailies once owned by similarly high-minded dynastic families that loyally surrendered control to big public corporations that prized earnings per share above all else. Editorial budgets at most papers, as well as TV and radio stations, have been squeezed hard for so long that asphyxiation is a mounting risk. The proliferation of Web sites and cable-TV stations has produced an abundance of commentary and analysis, but the kind of original reporting in which the *Times* specialize is anything, increasingly scarce.

In effect, the Sulzbergers have subsidized the *Times* in the name of good journalism and the prestige it confers over profits and the wealth it creates. In fact, for much of its history, the *Times* broke even. Recasting the paper into a publicly held corporation capable of pursuing profit as determinedly as *Times* editors

zers was the signal achievement of
ur Jr.'s father, Arthur O. "Punch"
berger Sr. Still, NYT Co. consistent-
ls to post the 25% profit margins of
big newspaper combines as Gan-
Co. and Knight-Ridder Inc. mainly
use of the *Times's* outside editorial
ding, which the paper does not
ose but which is thought to exceed
million a year.

r a time, Arthur Jr. enthralled
Street by adding double-digit
th to the Sulzbergian formula.
value of NYT Co. shares soared
from their 1996 low to their
high, boosting the value of the
y's 19% holding to \$1.5 billion. Like other Old Media
ies, the Sulzbergers have been able to maintain unques-
d control of their company by creating a new class of vot-
stock and reserving most of it for themselves. Among
the various branches of the Sulzberger family control
of the Class B voting shares.

the Bancrofts of Dow Jones & Co. and the Grahams of Wash-
ton Post Co. share the Sulzbergers' journalism-first philoso-
However the Washington Post has moved beyond news-
ring to a greater extent than has NYT Co., which in
ion to the *Herald Tribune* owns *The Boston Globe*, 15 small
newspapers, and eight television stations. Actually,
ur Jr. has increased his company's financial reliance on the
s by selling off magazines and other peripheral properties
red under his father. In short, NYT Co. is quality journal-
purest traditional play.

2004, the company clearly failed to parlay quality into the
th it will need to continue supporting the *Times* franchise.
Wall Street consensus is that the company will report net
ne of \$290 million for 2004, down 4% from the preceding
and a good 35% below the \$445 million it netted in the
a industry boom year of 2001. Revenues have plateaued at

There's no
question the [Blair-Raines]
experience changed him. [He's]
more open to other views"

was ecstatic, not realizing that he already had made the biggest
blunder of his tenure as publisher: naming Howell Raines as
executive editor.

RAINES, WHO HAD JOINED THE PAPER IN 1978 as a national cor-
respondent, had deeply impressed Sulzberger by shaking the
stodginess out of the editorial page as its editor during the Clin-
ton years. Raines campaigned hard for the promotion in 2001,
vowing to root out complacency and do whatever was needed
to raise the staff's "competitive metabolism." By most accounts,
Sulzberger saw Raines, then 58, as his journalistic alter ego and
collaborator in transforming the *Times* into a fully national,
multimedia franchise.

Just 18 months after self-proclaimed "change agent" Raines
had taken charge, the *Times* ran a devastatingly self-critical ar-
ticle recounting how Jayson Blair had plagiarized or made up at
least 36 stories. Sulzberger, who has often been accused of lack-
ing gravitas, will be a long time living down his flip initial re-
action to Blair's transgressions: "It sucks." Worse, Sulzberger
had no feel for how Raines was perceived in the newsroom,
where resentment of his arbitrary, self-aggrandizing ways had
reached the flash point. Three weeks after Sulzberger had un-

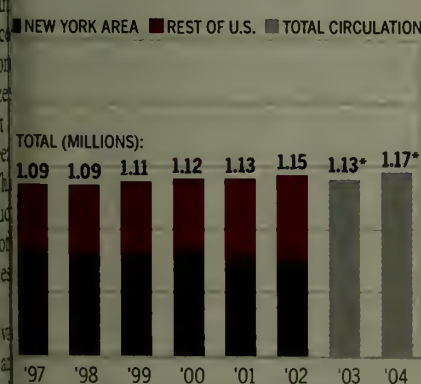
\$3 billion, give or take a few hundred
million, for five years running.

It wasn't that long ago—Apr. 8,
2002, to be precise—that all seemed
right in Arthur Sulzberger Jr.'s rari-
fied world. On that day, most of the
Times's 1,200 reporters and editors
gathered in its newsroom just off
Times Square to celebrate the paper's
record haul of Pulitzer Prizes. No
newspaper had ever before won
more than four Pulitzers in a year;
the *Times* won seven in 2002—six of
which recognized its Herculean cov-
erage of the September 11 terrorist at-
tacks and their aftermath. Sulzberger

Circulation by the Numbers

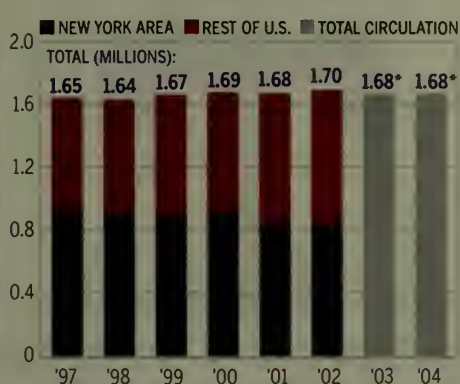
ditional gains mask a decline in the New York area. The real growth is online.

**Paid circulation, daily edition
of *The New York Times***



LOCAL CIRCULATION DATA NOT YET AVAILABLE
Data: Audit Bureau of Circulations

**Paid circulation, Sunday edition
of *The New York Times***



**Many more readers now see
the *Times* online than on paper**



Data: New York Times Co.

GOLDEN Can he make the long-lagging Trib turn a profit?



equivocally affirmed his support for Raines, the publisher fired him and Managing Editor Gerald Boyd.

The Blair-Raines fiasco devastated Sulzberger. But after a long period of introspection, he appears to have regained his confidence if not quite his swagger. "There's no question that the experience changed him," says Steven L. Rattner, a prominent private equity investor who has been one of Sulzberger's closest confidants ever since they worked together as young *Times* reporters in the late 1970s. "It's made him more open to other views and more careful to have a better sense of what's going on," he says. "I think it has been an eye-opening experience for Arthur, and that's never bad for any of us."

Sulzberger swallowed a heaping helping of humble pie in replacing Raines with Keller, a former managing editor whom he had passed over in promoting Raines. Appointed in July, 2003, Keller, 54, has been editor for only as long as Raines was but already has made a number of changes as fundamental as those that his predecessor promulgated yet never implemented. "I cringed every time I read that people thought my job was to come in and calm the place down because it made me sound like the official dispenser of Zoloft," says Keller, whose gracious manner has often been mistaken for passivity. "I saw myself instead as being, in some sense, a change agent without having to wave a revolutionary banner."

Keller has made so many high-level personnel changes that two-thirds of all newsroom workers now report to a new boss. He has also put into practice a string of reforms suggested by sever-

al internal committees formed in the wake of the affair. These include the appointment of a stand-in public editor, or ombudsman. By new counts, the *Times* now is much more responsive to reader complaints and criticism than it was.

AT CONSIDERABLE EXPENSE, THE PAPER also redesigned a half-dozen of its sections and upgraded its global culture coverage with the addition of 20 new reporting and editing jobs. "In the last year, there has been more change in a packed period of time than I've seen at any paper ever," says Sulzberger, who also credits the changes with "steadying our culture and lowering the temperature here." It is no mean feat to simultaneously prove morale and shake things up, but Keller insists to have to make certain that a happier newsroom will not again make for a more complacent newspaper. What Raines derided as "the *Times's* defining effortless superiority" might now be in remission. Has it been eradicated?

While the *Times* appears to be regaining its journalistic edge, it has not been rewarded with circulation gains. In 2004, the paper posted an infinitesimal 0.2% increase in the circulation of both the daily edition, which now stands at about 1.1 million, and the Sunday paper, which is just under 1.7 million. Since the national expansion began in 1998, the *Times* added 150,000 daily subscribers outside New York. It is thought to have lost about 96,000 subscribers in its home market. The net increase of 54,000 represents a 5.1% uptick, which compares with the 3.5% decline in

U.S. daily newspaper circulation over this period. What's more, the *Times* posted its gains despite boosting the price of a subscription by more than 25% on average.

New subscribers are increasingly hard to come by as newspapers' as advances in digital communications and the proliferation of alternative sources of news and information. For the under-30 set in particular, digital accessibility and interactivity tend to trump the familiarity of long-established names like *The New York Times*, CBS, or CNN.

The growing polarization of the body politic along ideological lines also is hurting the *Times* and its big-media brethren. One of the few things on which Bush and Kerry supporters agreed during the Presidential campaign was that the paper was unfair in its coverage of their candidate. Keller says the paper was deluged with "ferocious letters berating us for either being stooges of the Bush Administration or agents of Michael Moore." Complaints from the Right were far more numerous

even before the newspaper paid a bull's-eye on itself in running a front-page column by public editor Daniel Okrent, which was headlined "Is *The New York Times* a Liberal Newspaper?" Okrent's answer: "Of course it is."

What a growing, or at least increasingly strident, segment of the population seems to want is not journalism untainted by the personal views of the journalists but coverage that reflects their partisan beliefs—in the way many Fox News shows cater to a conservative constituency. For years, major news organizations have been accused of falling short of the ideal.

T

he *Times* has added 150,000 subscribers outside New York since 1998 but lost about 96,000 at home

partiality that they espouse. Now, the very notion of impartiality is under assault, blurring the line between journalism and propaganda.

For its part, the Bush White House has succeeded to a degree in marginalizing the national or "elite" press by walling off public access to much of the workings of the government and treating the Fourth Estate as merely another special interest group that can be safely ignored when it isn't being exploited. Bushies particularly dislike the *Times*, which, in their view, epitomizes the Eastern liberal Establishment. In his acceptance speech at the Republican convention, George W. Bush mocked the *Times* for what he considered its overly pessimistic coverage of post-World War II Germany. "Maybe that same person is still around, writing editorials," he joked.

The *Times* also is under attack from another branch of the federal government—the judiciary. The paper figures centrally in most of a half-dozen pending court cases that collectively pose a dire threat to the traditional journalistic practice of assuring confidentiality to whistle-blowers and other informants. In October, a federal judge ordered Judith Miller of the *Times* imprisoned for up to 18 months for refusing to testify before a grand jury investigating the leaking of the identity of CIA operative Valerie Plame to conservative columnist Robert Novak. Miller, who researched the Plame affair but never wrote about

it, remains free pending a review by the federal Court of Appeals in Washington.

Sulzberger, who spent six years as a reporter, is outraged that journalists are being slapped with contempt charges for refusing to yield confidential sources to prosecutors. "Reporters are going to jail for doing their jobs, and that's just wrong," he says. The publisher has been less outspoken in responding to the paper's political assailants. In an interview with *BusinessWeek*, though, he denied his paper is biased in its coverage of national politics or the war in Iraq or even that it is liberal. The term he prefers is "urban," says Sulzberger. "What we saw play out in this election was urban vs. suburban-rural, not red state vs. blue state," he says. "We are from an urban environment; it comes with the territory. We recognize that, and we can't walk away from it, but neither can we play it politically. I don't think we do."

FOR THE FIRST TIME SINCE HE became publisher 12 years ago, Sulzberger must carry on without Russ Lewis at his side. Lewis, a loquacious lawyer who got his start as a *Times* copy boy in 1966, stepped down on Dec. 26 after seven years as president and CEO of NYT Co. His replacement is the 54-year-old Janet Robinson, a former schoolteacher who joined the company in 1983 and worked her way up through advertising sales. She played an important role in the national expansion of the *Times*

A Halting Recovery

As the flagship paper goes, so goes New York Times Co.



TWO ARTHURS
Sulzberger
and his father
in 1996

Businesses of the Times

PERCENT OF TOTAL REVENUES*

59.8%
NEW YORK TIMES
GROUP
(NEW YORK TIMES,
NYTIMES.COM,
INTERNATIONAL
HERALD TRIBUNE)

21.4%
NEW ENGLAND
MEDIA GROUP
(BOSTON GLOBE,
BOSTON.COM,
WORCESTER TELEGRAM
& GAZETTE)

14%
REGIONAL MEDIA
GROUP
(15 DAILY NEWSPAPERS AND
AFFILIATED WEB SITES)

4.8%
BROADCAST GROUP
(8 NETWORK-AFFILIATED
TV STATIONS, 2 RADIO
STATIONS AND WEB SITES)

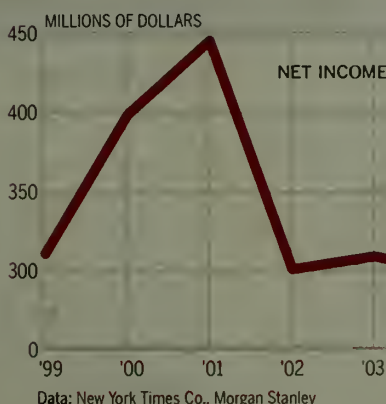
*FOR THE NINE MONTHS
ENDED 9/26/04

Data: New York Times Co.

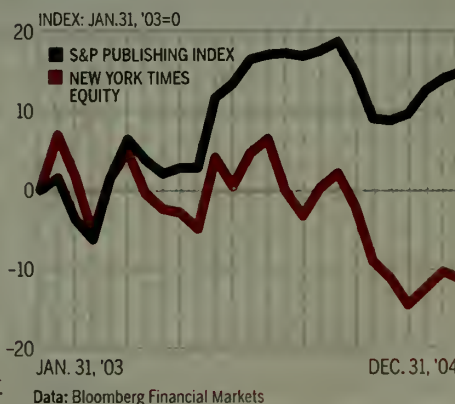
Revenues are going up...



...but earnings are weak...



...putting the stock under pressure



as its president and general manager from 1996 into 2004. On the Street, Robinson is known as a formidable manager who relentlessly puts NYT Co.'s best foot forward. "She's never met a number she couldn't spin positively," one analyst says.

The most pressing business problem the new CEO faces is a paucity of advertising. Through November, the *Times's* ad revenues were just 2.3% ahead of the previous year—a surprisingly weak performance, considering that the newspaper industry as a whole reported a 9.7% gain in national advertising revenues during the first nine months, according to TNS Media Intelligence/CMR. Expenditures on local newspaper advertising in the industry rose 6.6%.

A strengthening U.S. economy would help the *Times* in 2005 but wouldn't necessarily restore it to competitive parity. The huge runup in advertising rates over the last decade is forcing more U.S. companies to economize, either by shifting into lower-cost media or by homing in more precisely on their target markets. Neither trend bodes well for the *Times*, whose unique status as America's only metro daily with national reach appears to be putting it at a tactical disadvantage in some ways.

THE TIMES HAS MANY FEWER READERS outside of New York City than do the two largest national newspapers—*USA Today* and *The Wall Street Journal*—both of which have circulations far in excess of 2 million. "Those two papers tend to be a more cost-effective buy than the *Times* just because their circulation across the country is so much larger," says Jeff Piper, vice-president and general manager of Carat Press, a big media buyer. Even in the New York region, where the *Times* reaches only 14% of all adult readers, the paper's circulation is too diffuse to allow for effective targeting by ZIP Code—a technique that has enriched many other metro dailies with revenue from inserts.

Robinson maintains that there is nothing wrong with the *Times's* market position that a growing national and New York economy can't fix. Underscoring her confidence, the paper just imposed what is now an annual Jan. 1 ad rate increase, layering

This election was urban vs. suburban-rural, not red state vs. blue state"

a 5% hike atop a cumulative 3% increase since 2000. "We feel that premium quality equals premium price," Robinson says.

At the same time, the *Times* continues to move out from the 312 metro areas in which the paper is available in adjacent precincts. In October, it began printing the national edition in Columbus, Ohio, in a plant owned by the paper. That enabled it to sell paper in 100 new ZIP Codes while raising its presence in existing markets as far afield as Louisville. It plans to add seven new contract sites to its network of 20 printing plants by the end of the year.

The reinvention of the *Times* as a national paper has been accompanied by a steady loss of subscribers in the New York metro area. Its dwindling presence at home has been caused in part by forces beyond its control, including a big influx of English-speaking immigrants. However, taking the paper further upscale in pursuit of an elite nationwide readership has taken it out of some New Yorkers' reach (a seven-day subscription goes for about \$480 a year) and constrained its spending on local marketing and promotion. In addition, the *Times* has declined to join in the trend of introducing foreign-language editions or free editions for young adult readers. (It may be rethinking its free-paper aversion, as evidenced by *The Boston Globe's* recent purchase of a 49% stake in *Metro Boston*, a Sunday away tabloid.)

The substitution of national for local subscribers benefits the *Times* financially even beyond the sizable premium it commands on national advertising. On average it costs the *Times* one-third more to produce and deliver a newspaper in its home market (the only place where it owns its printing plants) than in the rest of America. But Sulzberger bristles at the notion that the *Times* is writing off its hometown readers or that a declining New York circulation is the inevitable result of national expansion. "We are not walking away from New York," he says. "But we are growing elsewhere."

The sphere of NYT Co.'s ambitions widened to encompass the globe when it muscled Washington Post Co. aside to gain full control of the *International Herald Tribune*, America's

Strategy Report Card

New York Times Co. aims to deliver top-notch journalism in any form, anyplace.

PRINT Instituted a radical plan to take the flagship paper national. For years, it looked like a masterful stroke as new ads and subscribers poured in. In an effort to build a presence in all markets, the *Times* prints at 20 plants across the nation. Lately, though, circulation growth has hit a wall.

GRADE: B+ (was A last semester)

DIGITAL the *Times* was early to see the potential of the Web. Today the *Times* Web site is attracting nearly 18 million visitors each month, and ad sales are growing 30% to 40% a year. The result: a \$100 million business in NYT.com with healthy margins and robust growth.

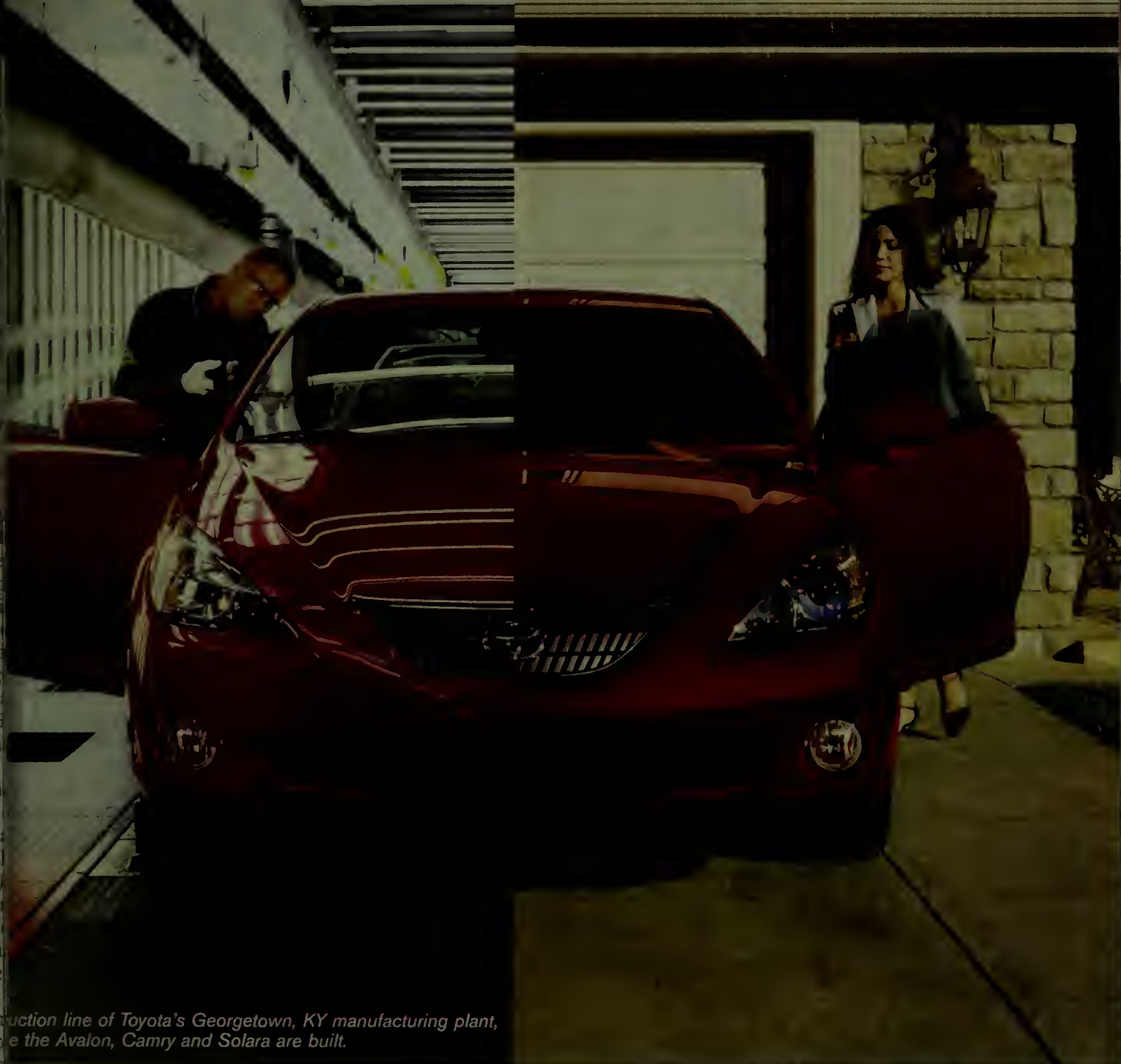
GRADE: A-

TELEVISION Has pursued several ventures for translating *Times* stories into documentaries. Two years ago the *Times* spent \$100 million for a one-half interest in Discovery Times, a cable channel. Efforts so far have been good for the brand, but not much of a moneymaker.

GRADE: C+

INTERNATIONAL Squeezed out *The Washington Post* in 2002 to gain full ownership of the *International Herald Tribune*. The IHT has more cachet overseas than the *Times*, so it won't carry the flagship brand for now. But it's getting a *Times*-style makeover. Growth prospects are uncertain.

GRADE: INCOMPLETE



production line of Toyota's Georgetown, KY manufacturing plant,
where the Avalon, Camry and Solara are built.

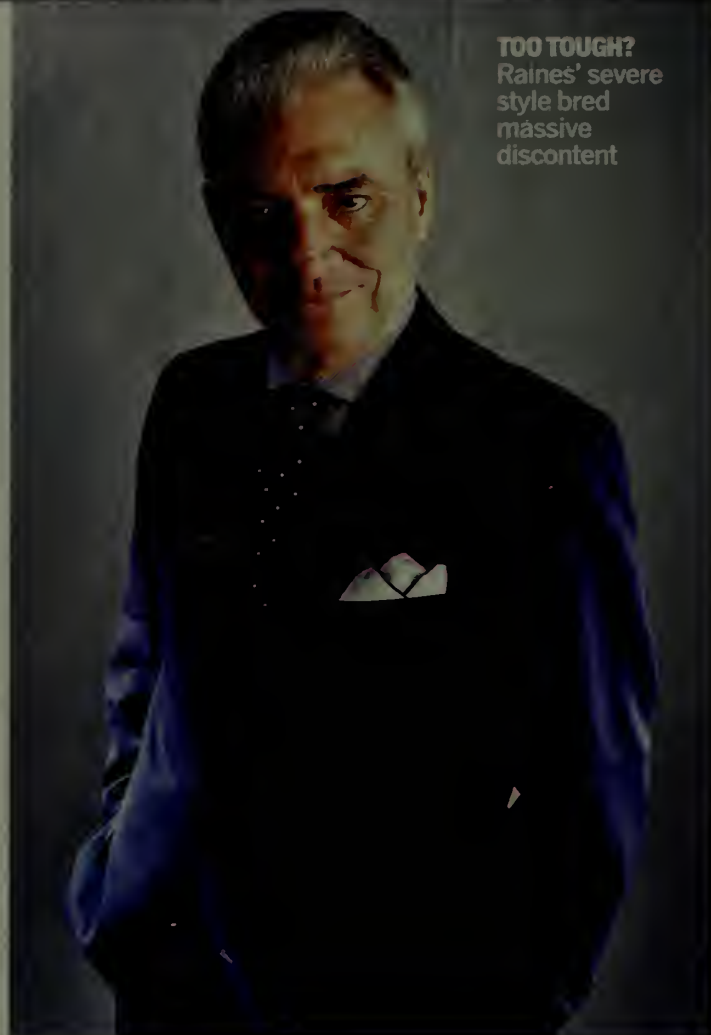
**Our vehicles don't just
make people to work,
they put people to work.**

For many Americans, Toyota is more than just a source of employment. For many Americans, Toyota is more than just a source of support, it's a source of income. With our eight manufacturing plants, sales and marketing operations, research and development facilities, and through our dealers and suppliers, Toyota's U.S. operations are responsible for more than 190,000 jobs. Every year, Toyota team members built more than one million vehicles in the U.S.* And with two new manufacturing plants under way, we're working to create even more jobs and opportunities in the communities where we do business.

*Components and vehicles are made using many U.S. sourced parts. ©2004

toyota.com/usa

TOYOTA



TOO TOUGH?
Raines' severe
style bred
massive
discontent

broadsheet voice abroad since 1887. The Post reluctantly agreed to relinquish its 50% interest for \$65 million after NYT Co. threatened to start a new paper to drive the IHT out of business. "The thing was going sideways and sooner or later was going to die," says Sulzberger, who was harshly criticized by some for lacking the gentlemanliness of his father.

The company considered making the *Tribune* over into a foreign edition of the *Times*, but decided in the end to maintain IHT's separate, international identity. "This needs to be a European paper for Europeans," says Michael Golden, a NYT Co. vice-chairman who was named publisher of IHT in 2003. Actually, the *Trib*'s 240,000 subscribers are concentrated in Europe but spread among 180 countries.

Under Golden, a slightly older first cousin of Sulzberger's, the *Trib* has adopted the *Times*'s playbook, if not its name. The transatlantic flow of copy from the *Times* has increased, but the *Trib* has enlarged its own news staff, too. It has also added pages, color photos, and new printing sites in Sydney, São Paulo, and Kuwait City. The *Trib* scored impressively in recent reader surveys in Europe and Asia and ad sales are rising, but they still amount to less than \$100 million a year. Golden and his cousin yearn to turn the *Trib*'s operating losses into profits, but the general track record of English-language newspapers and magazines abroad is discouraging.

Even if the IHT flourishes, it will be a long time before tributes significantly to its parent company's top or bottom.

The same is true of NYT Co.'s investment in television. The *Times* has built a cadre of television professionals in collaboration with a revolving cast of print reporters, has produced much fine work for *Frontline*, *Nova*, and other programs. In 2003, the *Times* moved beyond production into distribution, laying out \$100 million for half-ownership of a digital channel, Discovery Times, operated in partnership with Discovery Communications Inc. Discovery Times reaches 3 million homes—an impressive total for a fledgling channel—ratings are minuscule: In October, just 27,000 people tuned in during prime time, according to Nielsen//NetRatings.

ONLINE, THE TIMES ALREADY is making serious money. New York Times Digital (which includes Boston.com as well as Times.com) netted an enviable \$17.3 million on revenue of \$53.1 million during the first half of 2004, the last period for which its financials have been disclosed. All indications are that the digital unit is continuing to grow at 30% to 40% a year, making it NYT Co.'s fastest-revving growth engine.

Advertising accounts for almost all of the digital operation's revenues, but disagreement rages within the company over whether NYTimes.com should emulate *The Wall Street Journal* and begin charging a subscription fee. Undoubtedly, moving the site's 18 million unique monthly visitors would flee with a \$39.95 or even a \$9.95 monthly charge. One camp in the NYT Co. argues that such a massive loss of Web access would cost the *Times* dearly in the long run, both by shrinking the audience for its journalism and by depriving it of tens of millions in ad revenue. The counterargument is that the loss would more than make up for lost ad dollars by boosting circulation revenue—both from online fees and new print subscriptions paid for by people who now read for free on the Web.

Sulzberger declines to take a side in this debate, but says as if he is leaning toward a pay site. "It gets to the issue of how comfortable are we training a generation of readers to get quality information for free," he says. "That is troubling."

What's a platform agnostic to do? *The New York Times* and all print publications, faces a quandary. A majority of the paper's readership now views the paper online, but the core still derives 90% of its revenues from newspapering. "The business model that seems to justify the expense of producing quality journalism is the one that isn't growing, and that is growing—the Internet—isn't producing enough revenue to produce journalism of the same quality," says John Battelle, a co-founder of *Wired* and other magazines and Web sites.

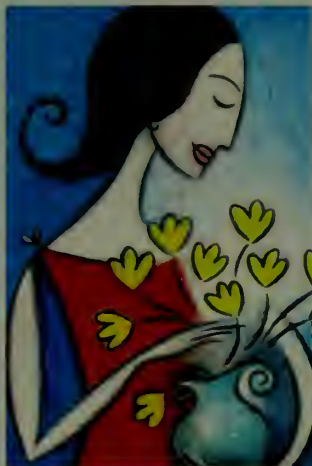
Today, Sulzberger faces an even bigger challenge than

he took charge of the *Times* in the mid-1990s. Can he find a way to rekindle growth while preserving the primacy of the *Times*'s journalism? The answer will go a long way to determining not only the fate of America's most important news outlet but also whether traditional, reporting-intensive journalism has a place in the Digital Age. ■

—With John Rossant in Paris
Lauren Gard in New York

The issue [is]
how comfortable are we training
a generation of readers to get
quality information for free"

BusinessWeek online For an interview with *The New York Times* editor Bill Keller, go to www.businessweek.com/extra



The 7 WONDERS of TARGETED ADVERTISING

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YES, I want to give a child a second chance at life.

- ☐ \$250 Provides cleft surgery for one child. ☐ \$ 50 Provides medications for one surgery.
☐ \$125 Covers half the cost of one surgery. ☐ \$___ We'll gratefully accept any amount.

Name _____

Address _____

City _____ State _____ Zip _____

Telephone _____ eMail _____

Charge my gift to my credit card: ☐ Visa ☐ MasterCard ☐ AMEX

Account No. _____ Exp. Date _____

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IMPORTANT PUBLIC HEALTH INFORMATION REGARDING CLEFT LIP & PALATE

What Is Cleft Lip And Cleft Palate?

A cleft is a separation in a body structure. Clefts that occur in the oral-facial region often involve the lip, the roof of the mouth (hard palate) or the soft tissue in the back of the mouth (soft palate). Two major types of oral-facial clefts are cleft lip/palate and isolated cleft palate. Babies with cleft lip/palate have a cleft lip which usually is accompanied by a cleft palate. In isolated cleft palate, the cleft palate occurs by itself, without cleft lip or other malformations. The lip or the lip and palate together fail to close in approximately 1 in every 1,000 babies born. Cleft palate occurs alone less often, appearing in approximately 1 in 2,000 babies.

What Causes Cleft Lip/Palate? The causes of cleft lip/palate are not well understood. Studies suggest that a number of genes, as well as environmental factors, such as drugs (including several different antiseizure drugs), infections, maternal illnesses, maternal smoking and alcohol use and, possibly, deficiency of the B vitamin folic acid may be involved.

Can Oral-Facial Clefts Be Prevented? While little is known about how to prevent oral-facial clefts, studies suggest that taking multivitamins containing folic acid before conception and during the first two months of pregnancy may help prevent cleft lip/palate and isolated cleft palate. Other studies have shown that fetuses with certain predisposing genes may be at increased risk for isolated cleft palate if their mothers smoke.

Women who are planning pregnancy or who are pregnant should avoid alcohol, which also can cause a number of mental and physical birth defects. Because some types of medications (such as some drugs used to treat epilepsy) have been linked to increased risk of cleft lip/palate, women who take medications for chronic illnesses should check with their doctors before they become pregnant. (They should not, however, discontinue their medication without discussion with their physician.) All pregnant women should use only medications prescribed by a physician who knows the pregnancy, and get early and regular prenatal care, beginning with a pre-pregnancy visit. Families with a history of cleft lip/palate, isolated cleft palate, or any other condition of which clefting is a part, may wish to discuss the chances of recurrence with a genetic counselor.

Can Oral-Facial Clefts Be Repaired? Surgery often is used to correct cleft lip/palate and isolated cleft palate. The timing and type of surgery depend upon a number of factors, including the presence of the surgeon, the health of the baby and the nature of the cleft.

Other Sources Of Information On Cleft Lip And Palate. In addition to valuable information we have tens of thousands of pages of information regarding cleft-related medical journal content, news articles and stories, important cleft resources for patients, their families, and cleft medical professionals, medical students and leading cleft organizations around the world. For more information on cleft lip and palate please visit the world's largest cleft website: www.smiletrain.org or call us at **1-877-Kid-Smile.**

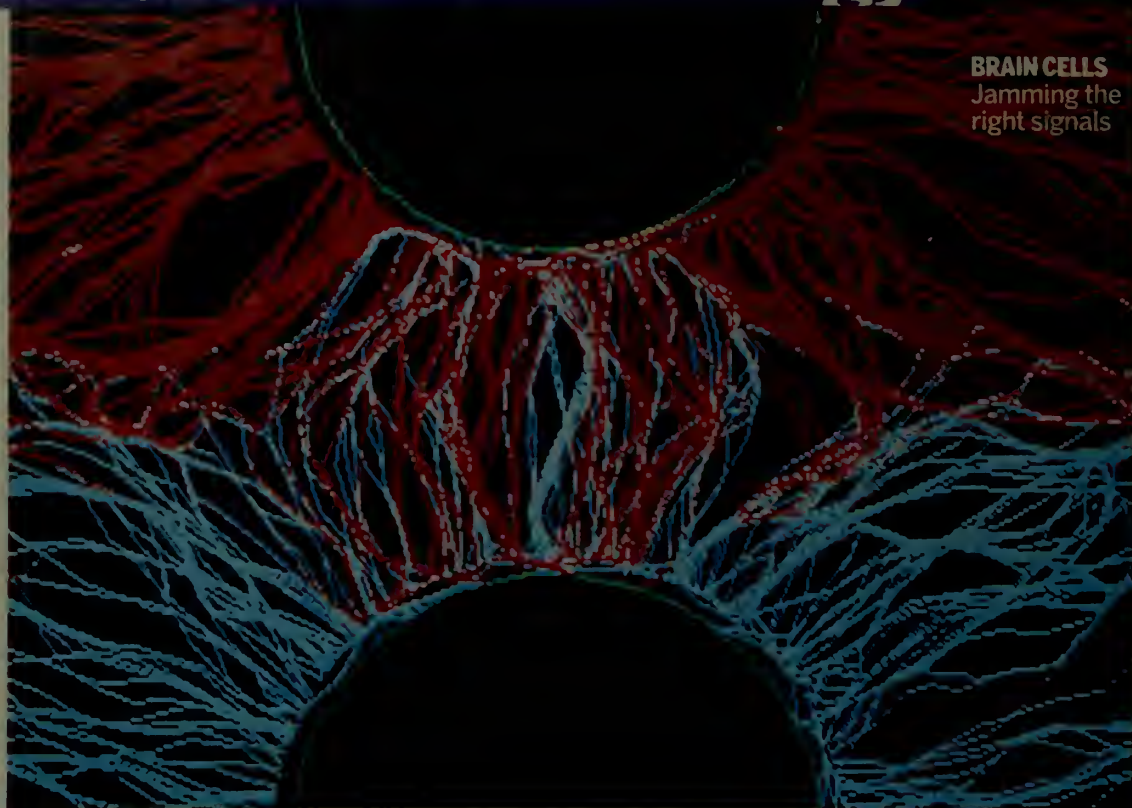
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No Pain, Some Gain

New drugs aimed at specific neuron targets promise relief from chronic agony

THE 50 MILLION Americans suffering from chronic pain got a little bit of good news in December—but just a little. Amid a flood of reports linking existing painkillers with cardiovascular problems, the Food & Drug Administration greenlighted two new medications—Prialt, from Elan Corp., and Lyrica, from Pfizer Inc.—that attack pain in completely novel ways.

Unfortunately, neither drug is designed to help millions of patients, as was the blockbuster painkiller Vioxx, which Merck & Co. withdrew from the market in September. And neither will bring the same rich rewards to its manufacturer.

The lack of a giant payoff could be a problem for future analgesics, given that both Prialt and Lyrica went through a far lengthier and costlier development

process than originally expected. The struggles by Elan and Pfizer to get these two medicines on the market highlight the immense difficulties that beset the entire field of pain research and treatment.

Both drugs are in the vanguard of a new generation of analgesics that act as precision bombs, targeting cellular mechanisms responsible for certain kinds of agony. The hope is that because these drugs are so precise, they won't cause side effects that would endanger broad groups of patients, as occurred with the widely prescribed COX-2 inhibitors such as Vioxx. But the fact that they address a smaller market could discourage drugmakers from taking costly risks on similar, targeted therapies in the future.

Prialt, derived from the

poisonous venom of a tiny cone snail, was first developed in the mid-1990s. But to satisfy the agency's safety concerns, Elan had to redo Prialt's clinical trials. Four years later, on December 1, the drug finally got the go-ahead—but only for patients with severe pain who cannot tolerate morphine.

Lyrica, Pfizer's success to its epilepsy drug Neurontin, also ran into several years of delays as the company fine-tuned its clinical trials. Pfizer had hoped to market the drug for epilepsy, anxiety, and pain, but the FDA approved it only for nerve pain associated with diabetes and shingles. Worse, the agency classified Lyrica as a controlled

substance under the purview of the Drug Enforcement Administration, which would limit its market. Standard & Poor's analysts say the drug eventually could generate \$1 billion in annual sales—less than the \$2.4 billion that Neurontin pulled in last year.

AGONIZING NEED

MEDICAL SPECIALISTS do not expect drug researchers to give up the quest despite the difficulties. "New drugs are desperately needed," says Dr. Allen Walton, an anesthesiologist at the Anderson Cancer Center in Houston. "We are not covering groups of patients with very resistant pain."

Virtually every drug approved for today blocks one of just two cellular mechanisms. Nonsteroidal anti-inflammatory drugs (NSAIDs) such as ibuprofen, as well as the COX-2 drugs that include Vioxx and Celebrex, all block pain-causing COX enzymes that incite inflammation around joints. For more serious pain there are narcotics such as morphine, codeine, and OxyContin, which

block opioid receptors in the brain that sense pain. These are the primary treatments for debilitating neuropathic pain caused by damaged nerves, which afflicts some 10 million people in the U.S.

The opioid drugs are considered the gold standard for pain treatment, because they can relieve just about

**They avoid
side effects
such as
heart
disease**

of suffering. But their downside—side effects and possible addiction—is huge for many patients. The NSAIDs have side effects, particularly gastric bleeding. On top of all the safety concerns, drugs often simply do not work. A national survey sponsored by Purdue Pharma LP, maker of Oxycontin, found two-thirds of pain patients considered over-the-counter pain medication ineffective, and 52% of those on prescription said the same.

NG SLOG

SUBJECTIVE NATURE of pain also complicates the administration of any. No blood test can determine how many patients are suffering, and many oath to complain. Doctors often ask, either. It's only in the past five years that pain treatment guidelines have become commonplace in hospitals. As a result, medical studies routinely find that

as 40% to 50% of patients are undertreated for chronic pain, defined as pain that lasts more than three months. This, despite the fact that Americans spent \$18 billion last year on prescription pain drugs.

A vast market, combined with the poor profile of existing drugs, got Big Pharma seeking better treatments in the 1990s. Since then, researchers have been able to identify several cell receptors and nerve channels involved in pain transmission. Developing drugs to moderate the pain has been a long process, however. "It's very, very difficult to find targets in the central nervous system that are both safe and effective," says Dr. Clifford J. Woolf, professor of anesthesia research at Massachusetts General Hospital in Boston. In addition, Woolf notes, any pain drug must be tested for its potential for abuse and addiction—a problem most other classes of drugs don't face.

Prialt shows no signs of being addictive, a big advantage over opioids. The drug blocks a calcium channel at the end of nerve fibers that transmits the pain signal up the spinal cord to the brain. Researchers estimate that it is hundreds of

times more potent than morphine, but far more toxic as well, making Prialt an unacceptable candidate for a pill or injection.

Instead, small quantities are pumped directly to the fluid surrounding the spinal cord via an implanted catheter and pump. The FDA restricted Prialt's use to patients with severe pain who no longer get relief from morphine, not a blockbuster-size market. Elan, which has yet to announce pricing, estimates that about 120,000 patients in the U.S. are candidates for Prialt.

Nevertheless, Prialt's approval may pave the way for other pain treatments derived from poisons. Wex Pharmaceuticals Inc., a Vancouver startup, is in clinical trials with a drug called Tectin, derived from the deadly toxin of the puffer fish, whose flesh is a risky delicacy known

But these painkillers aren't likely to bring rich rewards

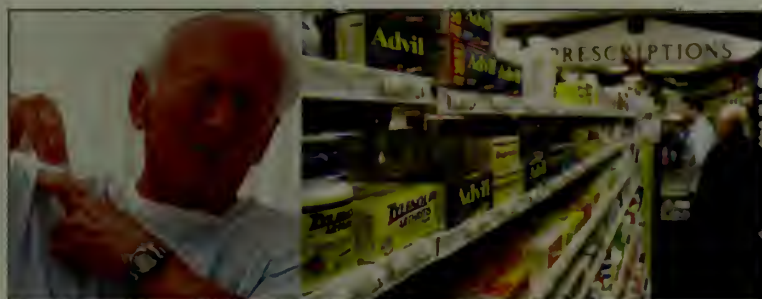
as fugu in Japan. Delivered by injection, Tectin blocks sodium channels that play a role in transmitting many types of pain signals. Another startup, AlgoRx Pharmaceuticals Inc., is testing a drug based on capsaicin—not a poison, but the substance in chili peppers that burns the skin. Capsaicin inhibits C neurons, the nerve cells responsible for dull, throbbing, continuous pain (as opposed to sharp, acute temporary pain).

Nicotine, the poisonous chemical found in tobacco, has also been shown to soothe pain in animals, but it is far too addictive for use in humans. As an alternative, Abbott Laboratories has spent a decade looking for drugs that target subsets of the nicotinic receptors, the nerve-cell proteins that suck up nicotine. The hope is that by homing in on just those receptors involved in pain, a drug will quiet overexcited nerve endings without risk of addiction.

After several attempts, Abbott has a nicotinic receptor pill, ABT-894, in early human trials. James P. Sullivan, head of the company's neuroscience discovery research, says 894 seems to work against a spectrum of neuropathic pain. And it's well-tolerated. "We still need to get it into (larger) trials to determine its best use, but we believe this is an innovative new mechanism for pain relief," says Sullivan.

It will be a few years, however, before 894—or any of the novel pain drugs in development—are ready for FDA review. Winning that approval is sure to be difficult in the wake of the safety issues swirling around the COX-2s. Still, the approvals of Prialt and Lyrica show that it can be done and are encouraging pain researchers. "They open people's eyes to other categories of drugs beyond opioids," says M.D. Anderson's Burton. Now drug companies just have to figure out how to develop those categories in a cost-effective way. ■

—By Catherine Arnst in New York



Precision Bombs

Because these medications are narrowly targeted, they won't endanger broad groups of patients

DRUG	TARGET	STATUS
CYMBALTA (ELI LILLY)	Brain chemicals serotonin and norepinephrine, which lower sensitivity to pain	Approved in Sept. 3 for diabetic nerve pain
PRIALT (ELAN)	N-type calcium channels, which transmit pain signal from one nerve to another	Approved Dec. 28 for treatment of cancer and AIDS patients
LYRICA (PFIZER)	A subunit of calcium channels called alpha-2-delta, found on overexcited nerve cells	Approved Dec. 31 for nerve pain caused by diabetes and shingles
TECTIN (WEX)	Sodium channels, which play a role in many types of chronic pain	Phase II/III trials in Canada for cancer pain
ALGRX 4975 (ALGORX)	Vanilloid receptor found on C neurons, the nerves responsible for dull, throbbing pain	Phase II trials for severe postsurgical and osteoarthritis pain
ABT-894 (ABBOTT LABS)	Nicotinic receptors that moderate the passage of pain signals between nerve cells	Phase I trials for a variety of nerve pains

Waking Up the Insomnia Market

Sepracor's Lunesta promises to spark an ad frenzy—and fresh safety worries

IF AMERICANS HAVE BECOME JITTERY about popping pills to treat their everyday ills, you would hardly know it from the optimism surrounding Sepracor Inc. On Dec. 16, the Marlborough (Mass.) company won approval from the Food & Drug Administration to market Lunesta, a new sleep aid.

Giddy investors pushed Sepracor's stock up 16%, to \$60, in the two weeks following the news, as the tiny, still-unprofitable company announced a \$60 million campaign to market the drug directly to consumers. Sepracor's ads, set to begin airing in February, will try to convince the bleary-eyed masses that they can safely take a pill every night to help them sleep.

There are plenty of customers, but it couldn't be a worse time to hit the airwaves with bold safety claims about a prescription drug. Recent revelations that painkillers Vioxx and Celebrex may raise the risk of cardiac disease have consumer groups howling that drug companies are abusing their right to market products directly to consumers. Critics who charge that Vioxx was overprescribed to people who would have done fine on aspirin say most insomnia cases can be treated with safer nondrug alternatives such as psychotherapy and meditation. Still, the drug companies, seduced by the wallets of 82 million Americans who battle insomnia, stand ready to entice restless sleepers with big ad campaigns that rival those of the sidelined painkillers.

Drug industry critics may be emboldened by Sepracor's ambitious plans for Lunesta. The market for drugs that treat insomnia is expected to double, to \$5 billion, by 2010, and this year alone could see even more new insomnia fighters from the likes of Takeda Pharma-

ceuticals North America and Sanofi-Aventis. Analysts predict Lunesta will drive Sepracor's revenues up 66% in 2005, to \$617.4 million. But Sepracor and some of its industry rivals are already looking to broaden the base of potential customers. Those companies hope someday to sell the drugs to patients with other illnesses, such as depression, for which insomnia is merely a symptom. "It's research and de-

velopment, but it's really marketing," says David P. Southwell, chief financial officer at Sepracor. "We think we can go into whole new markets for this drug."

To grab attention for Lunesta and head-on the anxiety over drug addiction, Sepracor is counting on a unique strategy. So far, Lunesta is the only prescription insomnia remedy that doesn't have a label suggesting that patients stop the drug after 10 nights. Sepracor persuaded the FDA to omit that restriction following clinical trials showing the drug worked over six months. Besides playing down the risk of addiction, Sepracor will stress that the drug helps patients asleep all night and that it causes little hangover.

RISKLESS?

MAYBE SO, BUT in the wake of Vioxx and Celebrex—also trumpeted as safe for everyday use—the FDA, which regulates all direct-to-consumer marketing, may raise an eyebrow at ads that underplay the side effects of sleep aids. That includes the risk that patients will become addicted. Henry A. McKinnell, ch-



Sweet Dreams

Amid a surge in concerns about side effects, drugmakers are planning promotions for a raft of upcoming sleep aids

LUNESTA Sepracor has the first insomnia remedy the FDA has approved for nightly long-term use. Sepracor plans to spend \$60 million in consumer advertising.

AMBIEN A reformulated version from Sanofi-Aventis, with approval expected in April, induces sleep and keeps patients from waking up too early. Sanofi spent more than \$37 million on ads in 2004.

RAMELTEON From Takeda Pharmaceuticals North America, it mimics the sleep-inducing hormone melatonin and could be approved this summer and pitched as a safe alternative for patients afraid of getting hooked on sleep drugs.

INDIPLON Pfizer's aid comes in two pills, one for all night and another for those who wake at 2 a.m. It's expected to be reviewed by the FDA this year.



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ecutive of Pfizer Inc., will probably be thinking about that later this year when the drug giant is expected to win FDA approval for its sleep drug, Indiplon. In November, Pfizer yanked two Viagra ads at the request of the FDA, which complained that they failed to mention side effects. And the company voluntarily withdrew all its ads for Celebrex after concerns emerged about heart-attack risk.

McKinnell concedes his industry is responsible for building the perception that all prescription drugs are without risk. Mandatory disclaimers and warnings, including whole magazine pages of small print, are overshadowed by slickly crafted backdrops of amorous couples walking their spaniels or dancing through fields of flowers. "The industry has moved towards creating an image [around a drug]," McKinnell says. "We need to rethink what the unintended consequences might be."

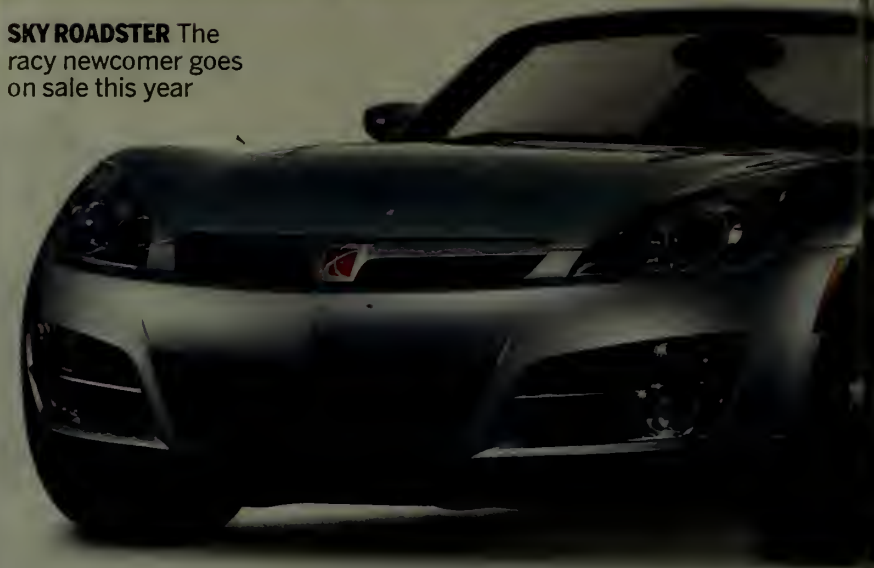
NASTY SPILLS

SAFETY CONCERNS could dog Sepracor and other new entrants to the insomnia market. Consumer advocacy groups such as Public Citizen complain that drugmakers aren't tracking carefully the link between sleeping pills and adverse effects, such as disorientation, that can lead to falls and hip fractures. Public Citizen's Web site, worstpills.org, cites independent studies that found 30% of broken hips in elderly patients who take drugs to treat psychological conditions are caused by sleeping pills. While ads for sleep drugs such as Ambien warn they can cause dizziness, Public Citizen's director of health research, Dr. Sidney Wolfe, worries that consumers don't get it. "Direct-to-consumer advertising is dangerously influential because it understates the risk," says Wolfe, who adds that six-month studies may not be enough to uncover risks of a nightly sleeping pill.

Sepracor's Southwell vows that warnings won't get lost in ad imagery for Lunesta. He and his competitors say they will continue to study the sleep aids. But those studies are designed more to expand the audience than look for unknown side effects. If those studies succeed, predicts Gary A. Lyons, CEO of Neurocrine Biosciences Inc., which developed Pfizer's Indiplon, "we could potentially double the market" for sleep aids. No doubt marketing budgets would soar, too. ■

—By Arlene Weintraub
with Amy Barrett in New York

SKY ROADSTER The racy newcomer goes on sale this year



Will These Rocket Rescue Saturn?

New models will have European styling, leather, chrome—and higher price tags

LAST AUGUST, GENERAL Motors Corp. Chairman G. Richard Wagoner Jr. and his new-car czar, Robert A. Lutz, went to their board of directors with a dicey pitch: They wanted to plow \$3 billion into GM's long-suffering Saturn division. GM's directors were understandably concerned. Sales at the 15-year-old unit finished 2004 down 22%, thanks largely to a fiasco with the L-series family car, which bombed so badly that GM took it off the market. Having squandered much of the goodwill generated from its early days of dicker-free showrooms and folksy marketing, Saturn today is mired in red ink, losing as much as \$1 billion a year. Many GM insiders think the division would be better left to go the way of Oldsmobile.

Faced with the huge costs of pulling an entire brand off the market—and one that still has fairly strong buyer loyalty—the board bought in for another pricey run at fixing Saturn.

What sold it was a raft of concepts among them, the racy Sky roadster and the stylish Aura sedan—that GM has been tinkering with for a couple of years. The Sky will show at the Detroit Auto Show next week. They also liked Lutz's risk: to push the brand upscale with more expensive cars. The Sky, which goes on sale late this year, and the Aura, arriving in dealerships in '06, kick off a blitz of new Saturns that will culminate with a new compact and Vue models in '07 and a large utility vehicle for 2008.

These new vehicles promise a serious upgrade over previous Saturns. Much of the new money GM is spending—an estimated \$800 million—will go toward converting Saturn's

Spring Hill plant to build steel-bodied cars instead of plastic bodies. (The company expands on hot doors; panels must be spaced apart, giving an appearance of poor construction.) The styling and interiors of the new vehicles will be heavily influenced

**GM says
buyer loyalty
makes the
brand worth
saving**

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by GM's European studios. The goal: sell enough cars at premium prices for the division to break even around 2008. "I'm so convinced that these cars will work," says Lutz.

Even critics say the new Saturns look better than any passenger car GM has built for the mass market in decades. But transforming Saturn from a brand known for cheap small cars into one that sells a wide

of fun and fashionable rides will be a challenge of planetary proportions. The new Saturns show that Saturn's image is still the worst in the market. Consumers see it as a cheap alternative to Honda and Volkswagen. The brand took a hit from its aging models and the L-Series debacle. And it didn't help that last year all of the nearly 250,000 Vue SUVs had to be recalled to remedy a sus-

pension problem. In early 2004, CNW Marketing Research in Bandon, Ore., surveyed consumers and ranked Saturn's image at 31st among 38 car brands—down from 23rd in 2002.

That's why Lutz tapped some of his top designers for the makeover. While the first Saturns had a young look to match the image of a completely new brand, later models were monuments to conservatism. This time, Lutz has seven studios around the globe crafting Saturn's new look. The original concept for the Sky was created by Simon Cox, a Brit who runs GM's London studio and had a hand in Cadillac's edgy new look. Opel designers in Germany are giving the cars some European flair. Inside they boast rich red and black leather and chrome accents. Says Dave Rand, executive director of interior styling for GM's North American operations: "We want people to be surprised it's a Saturn."

TARNISHED NAME

THEY'LL ALSO BE surprised at the price tag. All those improvements bumped up costs, of course. While GM isn't saying how much it will lift prices, the Sky is expected to sell for a shade more than the nearly \$20,000 Pontiac Solstice roadster, which uses the same engine and frame. Compare that with under \$14,000 for a base-level Ion. "They're nuts," says Art Spinella, president of CNW.

Indeed, GM will be hard-pressed to convince buyers that any Saturn is worth that much. When the company showed the forthcoming Saturns to consumers in internal clinics, they registered a 3.9 on GM's 4.0 scale of acceptance—indicating a genuine hit. But then GM slapped a Saturn emblem on the hood, and the score plummeted to a weak 2.5. "The cars look good," says AutoPacific Inc. Vice-President James N. Hall, but he jokes that "a lot of embarrassed people will be driving Saturns."

Even so, Lutz and his team say Saturn has advantages that make it worth saving. General Manager Jill A. Ladjiak points to the unit's young, educated buyers, most of whom are women. And though Saturn has had at most three models to offer, half its customers come from non-GM brands. "We've had a lean product portfolio," Ladjiak says. "Some people are surprised the brand is still standing." Lutz vows that GM will be patient as it tries to fix things. But consumers are likely to be less forgiving. If the new cars fizzle, Saturn could still find itself following Oldsmobile into early retirement. ■

—By David Welch in Detroit



GM Has a New Spin for Saturn...

One of its top designers is styling the new cars. GM is also adding European flair and richer interior cabins to compete with imports.

But It Still Faces Stiff Challenges

Saturn's brand image has fallen to 31st among 38 brands, from No. 23 in 2002. At the same time, GM has to persuade buyers to pay more for new models.

Keeping Your Job When You're Ill

Federal laws provide sick workers with some protection, but you need to play your cards carefully. **BY CAROL MARIE CROPPER**

KATHY FLORA TOLD HER boss and co-workers immediately when she found out she had breast cancer in 2003. Judi Swedek hid the news when diagnosed with the same disease several years ago. She scheduled radiation treatments at the end of her work day and declined chemotherapy, worried that symptoms such as hair loss would draw attention to her illness. "At the time I was more afraid of losing my job [at a New York investment bank] than I was of the cancer," says Swedek, now a business consultant in Colorado. ¶ If they had it to do over, each would handle the disclosure of her illness differently. Flora, who worked for an outplacement firm from her Bedford, N.H., home would be more deliberate about whom she told and when, while Swedek, who found the fear of discovery only magnified her stress, wishes she had been less secretive. ¶ As new treatments for cancer, AIDS, and other illnesses allow people to

continue working, more are facing issues. Recent court rulings have limited who can qualify under a 1990 law requiring employers to accommodate disabled workers. At the same time, the Supreme Court has made it easier to win coverage under a law providing extended unpaid leave.

REGULATORY ISSUES

MORE THAN 130 MILLION Americans have some chronic condition. These can range from common ailments like arthritis to high blood pressure to cancer and neurological disorders, according to a study at Johns Hopkins University. Many have no impact on an employee's ability to do the job, serious ones raise questions for sick employees and managers. When and how should an employee tell about an illness? Should workers know? How can one decide



SWEDEK Keeping her illness a secret at work only added to her stress

While sick employees need to understand their rights, litigation should be a last resort, says David Landay, an attorney who represents the chronically ill. Who needs a lawsuit while struggling through an illness? Not to mention the cost, which L. Susan Slavin, a Jericho (N.Y.) litigator, says can easily run \$50,000, even if the case is settled.

When deciding how to handle news of an illness, Landay advises talking to a company veteran who can say how other sick employees have been treated. Some companies—fearful a chronic illness will jack up their insurance rates or that the work won't get done—push sick workers out or into a lesser job, says Slavin. Large companies are better with chronic ill-

ness than small ones, she says. It's easier for them to cover an employee's absences, and the insurance risk is spread among more staffers. Plus they have human-resource workers and in-house lawyers who know the company's obligations under the law.

Some practical reasons argue for disclosing an illness. Hiding it can be emotionally draining and interfere with treatment, as Swedek discovered. And if you haven't told your boss, you're not protected from discrimination under the ADA. If you'll need an accommodation under the ADA (time off for treatment, say, or to work at home), your company will have to know. Ditto if you'll want to take a leave under the FMLA. Letting co-workers know may mean the difference between their support or resentment as they take on some of your duties.

When you tell, do it in a way that pres-

ents solutions, not problems, advises Page Tolbert, a social worker at Memorial Sloan-Kettering Cancer Center in Manhattan. Wait until you know what kind of treatments and time away will be required (something Flora wishes she had done before alarming her supervisor). Then, you can sit down with suggestions for covering your absences. "Bosses feel much calmer if you go in with a plan rather than if you march in and say: 'I'm going to disrupt the office,'" says Tolbert.

Review your company health, life, and disability coverage and then find out if you can upgrade during the company's annual sign-up period without taking a physical, Landay advises. If you need to look for another job, know that group plans, by law, generally must cover pre-existing conditions as long as you don't allow your insurance to lapse more than 63 days, and you were covered for 12 months under your former plan, he says. Landay suggests you don't tell a prospective employer about your condition—at least not till you get a job offer.

CONSIDER YOUR BOSS

REMEMBER YOUR illness likely presents difficulties for your boss as well. Frank Morris, a labor and employment lawyer in Washington tells of one company where three of four tech help desk employees went out under the FMLA at the same time. The company had to hire an outside firm to pick up the slack.

Still, many businesses want to accommodate sick employees, considering it a morale booster and a better alternative than finding and training a replacement. While the law doesn't require FMLA leave to be with pay, New York Life, an insurance company based in Manhattan, continues to pay those on medical leave, with duration depending on length of service.

Both Swedek and Flora left their jobs within months of their diagnosis. In the end, Swedek decided she wanted a less pressured environment and moved to Colorado. Flora's position was cut during a restructuring. Both women successfully completed their cancer treatment.

Hanging on to a job can mean medical insurance, pay, and stability. But, says Flora, while your co-workers care about you, they aren't family. At some point, what they care about most is getting the job done. That's why it's important to manage your illness in the most professional way possible. ■

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may have their own laws.

Where to Entrust Your Trust?

States are coming up with new incentives, so it pays to look around. **BY ANNE TERGESEN**



PICKING THE RIGHT LOCATION is the key to success in real estate. Now it's also a crucial decision in the sleepy world of trust funds. To lure a piece of the trust business, some states have recently enacted laws designed to make it attractive to establish trusts within their borders. As a result, it's possible to improve your trust's return, life span, and defenses against creditors simply by locating it in a par-

ticular state. "Shopping for a trust locale has become de rigueur in the industry," says Michael Smith, managing director at Deutsche Bank.

Which state you choose—you don't have to use your home state—will depend on your goals. For example, to maximize your trust's returns, you might pick a state with no income tax—or at least none on trusts. Meanwhile, those intent on a lasting legacy can choose a state that allows trusts to live forever instead of for just a few generations. If legal liability is a

concern, you might look at the few that permit "domestic asset-protect trusts"—or trusts designed to protect you, while still protecting the assets of others. A word of caution: Since trusts are irrevocable, you can't change your mind once you set one up.

While investment decisions will dictate your trust's financial success, state law can lend a helping hand by selecting a tax-friendly jurisdiction. Trusts pay federal taxes on their capital gains and any income they don't pass along to beneficiaries. They're also subject to federal estate, gift, and generation-skipping taxes. But you can select a host state that either has no state income tax or exempts trusts from paying it (table).

Be forewarned that this area of the law can be complex. Delaware, for example, exempts trusts with in-state trustees from paying its income tax—but only if the beneficiaries live in other states. And no matter where your trust is, it may be liable for Illinois' income tax if the person who establishes it lives there, says Ed O'Connell, managing director at Citigroup Trust. In contrast, New York and New Jersey generally impose no income tax on resident trusts as long as the trustee is based in that other state and the trust holds no real estate-based property or investments that generate income. To figure out your trust's exposure, check the laws of each state in which a trustee, grantor, and beneficiary live, says Catherine Keating, managing director at JPMorgan Private Bank.

90-YEAR SPAN

WHERE YOUR TRUST is located can make a big difference in its long-term life span. Most states require trusts to dissolve after about 90 years, a feature inherited from English common law. But 22 states plus the District of Columbia have changed their laws to permit irrevocable trusts with in-state trustees to endure for multiple generations (table). That's a big deal: Since a trust worth \$1 million today grows 8% a year and makes a 3% annual payout to heirs will have \$131 million in 100 years, according to Rick Renno, managing director at Wilton Trust.

Another reason to shop for a trust locale is to better protect your money from legal action, including shielding your assets from creditors should you face bankruptcy. Money put into an irrevocable trust for someone else—say, your children—is generally off-limits to creditors. But seven states, including Alaska, Delaware, and Nevada, have recently enacted laws that let you name yours-

fiary of a protected trust. Until
tly, you could get this type of trust
by moving your money offshore to
s including the Cook Islands in
outh Pacific.

ll, because these new trusts have
be tested in court, they're not bul-
of. You also have to be willing to
your trustee control over distribu-
And the trust can be ruled invalid
ublished after a legal claim arises.
ouldn't use them to replace other
protection techniques, such as lia-
insurance," says James Kronen-
principal at Bessemer Trust.

ou already have a trust, can you
it to another state to take advan-
of these new laws? Success is more
if your trust document lets you
e trustees and doesn't require a
ic state to govern it. But while
hing to an out-of-state trustee
help your trust reap income-tax
ts, it's unlikely to result in a longer
an. Why? Many trusts set an expi-
date in the time frame allowed by
home state. A donor can go to court
quest a change. But that can be ex-
ve and time-consuming—and
s no assurance of success. That's
e's key to choose the right state for
trust from the start. ■

x-Friendly States

states with little or no income tax on trusts.

ka	South Dakota
ware	Texas
da	Washington
ida	Wyoming

Morgan Stanley Bank

Starting a Dynasty

states that allow trusts to last for generations

ka*	Nebraska
ona	New Hampshire*
rado	New Jersey*
ware*	Ohio
of Columbia	Rhode Island
da**	South Dakota*
o*	Utah***
is	Virginia
na	Washington**
ie	Wisconsin*
land	Wyoming***
ouri*	

* Tax treatment more assured in these states
the maximum trust duration is 360 years.
** 100 years *** Wyoming and Utah limit trust life
to 100 years
Data: Trusts & Estates, Dec. 2004

BEEFED-UP ENGINE The
C6 has 400 hp, same as
the Ferrari 360 Modena



More Vroom for The Buck

At \$45,000, the new Corvette can take on plenty of pricier sports cars. **BY DAVID WELCH**

AMONG CAR BUFFS, few events are as heralded as the release of an all-new Corvette. The 'Vette gets attention because it's the only true sports car with an American heritage. And at a price of around \$45,000, a lot of people can actually afford one.

The sixth-generation Corvette, or C6 for the cognoscenti, is only a modest change from the outgoing car, but it delivers a lot of punch when it comes to the performance-for-the-money pledge. The beefed-up V-8 adds 50 horses to the old car's motor for an even 400 horsepower. That's the power offered by a Ferrari 360 Modena, 60 hp more than a Porsche 911, and only five horses shy of last year's Z06, the 'Vette's superperformance version.

Despite carrying over a significant number of its parts from the last-generation Corvette, the C6 offers a tighter ride than the old one did. The Detroit-area roads were a little slick during the week I tested it, but I was able to throw the car around some tight bends. The newly engineered suspension is stiff, and the steering is as precise as anything I have driven. I floored the gas pedal while making a left turn. It held its traction with minimal skid-

ding and kept its trajectory with precision.

Like the Cadillac XLR—built alongside the Corvette in Bowling Green, Ky.—the Corvette has General Motors' new magnetic ride control, which changes the stiffness of the suspension by measuring the roughness of the pavement. That means the ride can soften up if you hit a few potholes.

Up close there are notable differences between this Corvette and the C5. Besides the absence of flip-up headlights, the car is five inches shorter, so it doesn't have the long, cartoonish nose hanging out in front. But like the C5, it still has a fat rear end that's nearly as tall as the car itself. Some nice creases in the plastic body—especially the hood view from the front seat—make the car look edgier.

So why can GM sell a 400-hp performance coupe for at least \$35,000 less than its European rivals? For one thing, a much upgraded interior doesn't have

the rich leather feel or artistic panache of the new cars from Old World producers such as Porsche and BMW. There are some flashes of aluminum around the dash, but dark plastic abounds where exclusive cars offer stitched leather and crafted wood. Yet if you're looking for street performance, the C6 can take on a lot of its more expensive competitors. ■

But in its interior, plastic abounds, not leather

On the Road—With Your Favorite Museum

These tours aren't cheap, but they offer top-notch access. **BY SUSAN GARLAND**

ZOOLOGIST WILLIAM Stanley from Chicago's Field Museum spends much of his time in Tanzanian forests studying mammals in their threatened habitat. But for a couple of weeks each winter, he and another museum scientist lead a group of tourists on a safari in the African country's wildlife-teeming parks.

With his firsthand knowledge of the ecosystem, Stanley provides a depth of information that travelers on other tours rarely get. At campfires each night, he talks about his childhood growing up in Kenya. Stanley, collection manager of the museum's division of mammals, says he enjoys sharing his experiences: "I love to see the expression on people's faces when they first go to the Ngorongoro Crater," a 102-square-mile crater filled with rhinos, cheetahs, and lions.

The Tanzanian safari is one of about eight tours led each year by Field Museum scientists. The giant Smithsonian Institution runs about 250 trips a year. This sort of tourism, though not new, is poised for growth as the baby boomers approach retirement. "They are educated, they are healthy, and they have been lifelong learners," says Amy Kotkin, director of Smithsonian Journeys.

Travelers can select among expeditions to remote locations, city-based excursions, hiking or biking tours, and cruises. In most cases you must be a museum member, but the membership fee is usually small.

The trips tend to be pricier than comparable commercial offerings. The price includes at least one full-time expert, a tour manager, educational materials, high-end accommodations, local guides, and private receptions. Sometimes museums make contributions to institu-



tions they visit. Airfare is usually extra.

For example, a 20-day American Museum of Natural History expedition in June to Siberia, Mongolia, and Tuva costs \$8,665, not including airfare to Moscow. The trip features several airplane flights and two helicopter rides, including one over the Gobi Altai Mountain range; lunch in a hunter's log cabin in a lakeside village, and a stay in a barge hotel on a bay. In Tuva, a region in Siberia rarely seen by outsiders, travelers will attend concerts of traditional *hoomi*

(throat) singing, where vocalists produce several distinct sounds at a usually duplicating natural sound as a rushing river.

Although most programs are geared toward adults, several are designed for families. On the American Museum of Natural History's family trip to China in June, participants will get to tour a breeding facility and make Chinese

Museum trips usually are designed around a theme, such as the Walters Art Museum of Baltimore's September

"Andalusia: Treasure of Spain," the group will accompany a museum curator to examine the influence of Muslim, Jewish, and Christian cultures on architecture and art. If flowers make you sneeze, perhaps you should pass on Smithsonian's "Gardens of the Caribbean: Barbados to Antigua" yacht tour in February.

AND THE VELVET ROPE

BENEFIT OF museum programs is access to places not usually on the travel circuit. Curators and scientists of like travelers off the beaten track to where they've done research. Long built relationships with experts

the only ones allowed in," she says.

Museum curators also use their contacts to arrange meetings with renowned scientists and artists. In May, Ian Tattersall, the American Museum of Natural History's curator of anthropology, is leading a trip to Georgia, Armenia, and Azerbaijan. His former colleague, a renowned Georgian paleontologist, directed the excavation of Dmanisi, where the most ancient human remains outside Africa were found. As a result of that contact, the group will spend at least two days with the Georgian scientist, who in his office will show them the original skulls from the site and give them a private tour of the State Museum of Georgia, which he directs, says Alicia Stevens, director of the museum's Discovery Tours.

Beat the crowds by taking a tour after regular hours

When the Oakland Museum of California designs art tours, travelers meet with local artists. In Japan, a group visited the studio of a master carver of theatrical masks. He told

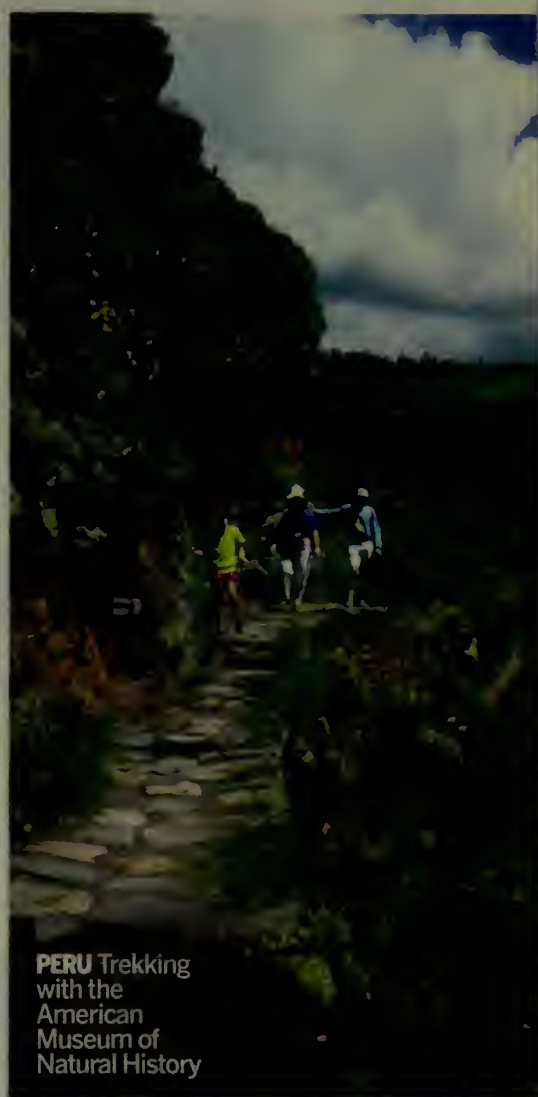
them ancient stories as they watched him work, according to Barbara Bigelow, travel coordinator for the museum's art guild.

Program directors say most travelers are middle-age singles and couples, without expertise on a trip's subject matter. Jill Bogard, 53, of Washington D.C., who went on a Smithsonian walking tour of Tuscany in September, says her fellow travelers were from all over the country. "They tended to be educated," she says. "They wanted to know the history of the place and a sense of the culture."

Finding out about available trips requires some legwork, as there is no master list of museum-sponsored travel programs. Some institutions provide limited information on their Web sites, but you still may need to use the site's search engine, or call the museum directly.

If you have a specific cultural or scientific interest, check out specialized museums. For aficionados of Eastern art, the Society for Asian Art, which is affiliated with the Asian Art Museum in San Francisco, is planning a May trip to Japan where travelers will visit potters, basket weavers, paper makers, and other artisans in small towns. In May, the Jewish Museum in New York will be hosting a trip called "The Jews of Ireland."

If a particular trip catches your eye, ex-



PERU Trekking with the American Museum of Natural History

amine a detailed itinerary before signing up. "Even if you have a focused interest in art, you need to look at the trip carefully because you may not want to spend all of your time in art museums," says Smithsonian Journey's Kotkin. Prospective travelers also should ask about the tour leader. In many cases, a museum will not send its own curators or scientists but will arrange for an outside expert, such as a professor with extensive knowledge of the destination and subject.

Museums usually work with travel firms to make arrangements, including providing local guides. Make sure that the museum has customized the trip instead of simply putting its imprimatur on an off-the-shelf program. "You want to know if the people in the institution are creating the trips and seeing through all of the details of the program," says Stevens.

Though museum trips are expensive, sailing by clipper ship around New Zealand with a world-class zoologist on board or walking through Rome with an art historian by your side may well be worth the admission price. ■



ENGLAND Touring Dover Castle with a Smithsonian Journey guide

the world, tour leaders can gain access to private art collections, gardens, archaeological dig sites, and can arrange after-hours visits to museums, houses, libraries, and churches. During a tour of cultural attractions in Europe sponsored by the Walters Art Museum, Carol O'Connell of Baltimore, visited a library in a cloister in England. She wore special gloves to touch pages of 15th-century books. "I see other people looking into the book through a Lucite door, but we were

Lost Your Digital Photos? Stay Calm

New software can recover images from your camera's memory card. **BY LARRY ARMSTRONG**

YOU'VE MADE IT through the holidays, and you have a digital camera full of pictures to prove it. Or so you think. When you finally start to transfer them to your computer to print out the highlights, your camera responds with an error message. Or it simply acts as if there's nothing on the memory card.

It's every shutterbug's nightmare, discovering that the priceless Kodak moment is nothing more than a fleeting memory. Maybe you accidentally pressed "delete all" when you meant to erase a single dud. Or you reformatted the card, erasing all the images and index data, thinking that you'd already saved the snapshots of last summer's vacation to your computer. Maybe you corrupted the memory card by shooting with low batteries, or by ejecting a card while the camera was still saving an image to it, or by continuing to shoot and delete without ever reformatting the card.

I've been looking at some of the ways to recover those seemingly lost pictures. Sometimes it's as easy as hooking up a \$20 card reader to your computer and using it to transfer your pictures instead of copying them directly from the camera itself. If that doesn't work, you can buy software that will recover the images from a damaged or reformatted card or even snapshots you've deleted. (Some Sony, Olympus, and Fujifilm cameras permanently erase images when the card is reformatted, so the software can't recover those.)

You can also send your card to a lab that specializes in extracting images from damaged cards, such as FlashFixers (flashfixers.com) or LC Technology (lc-tech.com.) The price ranges from \$50



to \$200, depending on the size of the card, and you don't pay if they can't retrieve your pictures.

Both those companies also sell image-recovery software, or you can buy it directly from card manufacturers such as Lexar and SanDisk. Lexar's Image Rescue (lexar.com) is \$29.95; SanDisk's RescuePRO (sandisk.com), made by LC Technology, is \$40. Both will work with any brand of card. Lexar and SanDisk include the software with their professional or high-speed cards that cost 10% to 20% more than standard cards. Other programs include MediaRecover (mediarecover.com) for \$29.95 and PhotoRescue from DataRescue (datarescue.com) for \$29.

Before you purchase any software, download and try out the free trial version. If the demo recovers an image,

chances are the software you buy will work, too. The difference? In most cases, the trial version will give you thumbnails of your pictures, watermark them with text, or recover only a limited number of images.

SEND IN THE CARD

TWO OF THE PROGRAMS are much risk free. LC Technology will refund the \$39.95 price of its Photorecovery software if the free demo works and the trial version doesn't. If FlashFixer's ImageRecall can't save your pictures, you can return your memory card to the company and they will try to find them using more advanced techniques. It credits the \$39.95 price of the software toward its lab fee.

I loaded three programs—Rescue Image, Image Rescue, and ImageRecall—on my computer and used them to recover pictures from a Corbis Flash card. I was told to deliberately corrupt the card, but I "lost" individual images by opening the card door on my camera while it was still saving the image and data to the card. The camera nor my computer could see the pictures, but all three programs could find and write them to my computer's hard drive. I also reformatted the card: The software found pictures,

including a hundred or so that I'd deleted months ago.

The best way to ensure that you don't lose all the pictures in your camera is to take a few precautions. Don't yank the card when the camera is on, and shut off the camera immediately after taking a picture. Always reformat the card after you've transferred the pictures to your computer, and reformat it in the camera, not on the computer. If you accidentally run a card through the washing machine, let it dry for a few days; chances are the pictures will still work. If you have more than one digital camera, don't swap cards between them without reformatting.

So you have no need to despair. Your card develops a glitch, you're unable to save your snapshots—and then, the ephemeral memories of a special holiday or vacation. ■



Mark Mallon
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EDITED BY TODDI GUTNER



INVESTING

China Made Easy

TO CAPITALIZE ON China's powerhouse economy, Wall Street has introduced two exchange-traded funds that bundle Chinese stocks into one easy-to-trade security. The problem is differentiating between the two, the **iShares FTSE/Xinhua China 25 Index Fund** and the **Golden Dragon Halter USX China Portfolio**.

These ETFs have a lot in common. Four of their top 10 holdings are the same, including **China Mobile Communications** and **PetroChina**. And both are concentrated, with iShares holding just 25 stocks and Golden Dragon 43.

Dig deeper, though, and differences emerge. Golden Dragon focuses on the companies' American depositary receipts, which trade in the U.S. and so have to meet U.S. accounting and disclosure standards. iShares is skewed toward Hong Kong-listed companies, which don't have to follow the same rules.

Golden Dragon has the lower expense ratio, 0.6%, vs. iShares' 0.74%. Still, Paul Mazzilli, **Morgan Stanley's** director of ETF research, says the iShares fund will be "more popular and liquid," in part because it's run by ETF giant **Barclays Global Investors**. Barclays also has the muscle to negotiate bargain trading commissions. That could be enough to overcome Golden Dragon's expense edge. —Anne Tergezen

STOCKS

THE 58 COMPANIES on the Standard & Poor's 500 Dividend Aristocrat list are truly noble. They've increased their dividends for 25 consecutive years. An additional 27 from S&P's MidCap400 and SmallCap600 meet the same criteria.

STOCK SYMBOL	SECTOR	DIVIDEND YIELD*
Consolidated Edison ED	Utilities	5.2%
Altria MO	Consumer staples	4.8
Bank of America BAC	Financials	3.9
May Dept. Stores MAY	Consumer discretionary	3.3
Pfizer PFE	Health care	2.9
Donnelley (R.R.) RRD	Industrials	3.0
ALLTEL AT	Telecommunications	2.6
PPG Industries PPG	Materials	2.7
Automatic Data Proc. ADP	Information technology	1.4

* Data: Standard & Poor's Investment Services

S&P is not making judgments about the next 25 years, but history counts. For a complete list, go to standardandpoors.com/indices and under Index Highlights, click on S&P 500 Dividends.

DINING

A NICE CAB TO GO WITH THAT SCORPION

WANT TO KNOW the right wine to serve with sautéed rosemary rattlesnake or baked scorpion on endive leaves? Check out "A Taste of Adventure"—a free dining and lecture series from The Explorers Club and Redwood Creek Wines. Participants sample exotic cuisine paired with various wines as experts discuss everything from sharks to the grizzlies of Yellowstone National Park. Events are scheduled in Miami on Mar. 18, Los Angeles on Mar. 2, and San Francisco on June 15. Call 888 281-8502 for reservations. —Michael

E-COMMERCE

GIFT-CARD TRADING MARKET

YOU GOT A GIFT CARD for Best Buy, you would prefer a book from Borders? Web sites are cropping up to let you swap, sell, or buy merchant gift cards. Swappers can go to **SwapaGift.com** or **cardavenue.com** to register cards they own, enter the amount they would sell or trade them for, and see what other cards are listed. What if your card is worth \$75, and the one you want is for \$100? On SwapaGift.com, you can throw in cash to do the deal. There's a fee, of course: SwapaGift.com charges a flat \$3.95. Cardavenue.com, where you can trade or auction off a card, gets 6% of card value plus 50¢ on a trade. On auction site **eBay** you have a lot more choices of cards but no one-to-one swapping. There you pay a listing fee and a minimum of 5.25% of the sale price. —Suzanne

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BY ROBERT BARKER

The Monday Morning Quarterback Report

January is great for fresh starts, but fresh starts for me begin best with long, hard looks back. I'm happy to see many past columns, particularly those on Applied Materials, Automatic Data Processing, Burlington Resources, Johnson & Johnson, Kimco Realty, and Korn/Ferry International, proved to be prescient. Yet I have to wonder, what might I learn from those that didn't?

With that aim in mind, and to continue an annual custom, I've looked back at columns at least one year old to find those that time and events proved wrong. Among them, my biggest misses (charts) seemed to fall into one of three categories:

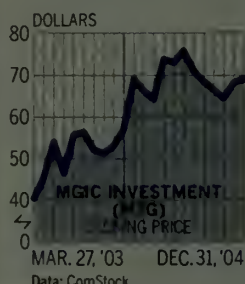
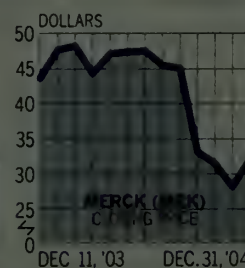
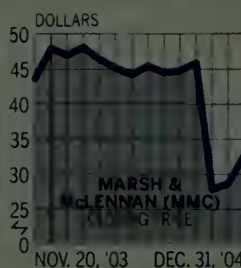
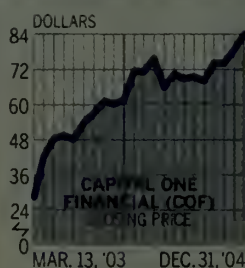
» **Selling the big trend short.** I'm hardly alone in my amazement that so many home prices have soared. Yet having company didn't make me right. Skepticism about home values led me in March, 2003, to question prospects for MGIC Investment, the No. 1 underwriter of private mortgage insurance. The stock sold then for 40; today, it's near 69, as home values remain high and the job picture brightens. Similarly, that same month I had frowned on Capital One Financial, the fast-growing consumer lender that then was under regulatory scrutiny. A company with a record of questionable controls and disclosures, it seemed to me, courted danger if consumer credit growth slowed or delinquencies rose. Maybe, but consumers kept borrowing, and Capital One's delinquency rate and write-offs fell. Then 28 a share, the stock now trades near 84.

» **Blinking past the big risk.** At 43 a share, Marsh & McLennan in November, 2003, already reflected all of the risk of New York Attorney General Eliot Spitzer's findings of investor-unfriendly behavior at its Putnam Investments mutual-funds unit. Much I got right. What I missed—despite a blunt warning from a shrewd colleague of mine—was the huge risk that Spitzer wouldn't stop at funds. When he next uncovered wrongdoing at Marsh's insurance brokerage unit, the stock cratered below 23. A few weeks later, I spied opportunity in Merck at 43 a share, figuring that with 13% of its sales going into research, something good was bound to come out of its drug pipeline. It may yet. But what I chose not to zoom in on was Merck's recent deep disappointments in moving compounds from clinical trials to pharmacies. Might those failures have affected management's eagerness to continue? Perhaps. What's plain is that Merck's Vioxx debacle kneecapped the stock, now under 32.

» **Undervaluing big momentum.** Lots of successful investors to invest only in industry leaders. One trouble with that strategy: It's rare when you can buy a leader's stock at a bargain. That led me in October, 2003, to hesitate over Simon Property Group, whose growth I suspected would slow. Instead, Simon kept expanding, both in the U.S. and abroad. From 44 a share, the stock has risen to record highs near 62. The next month, I likewise did not credit hotelier Starwood Hotels & Resorts Worldwide's considerable momentum, which had grown into the hotel biz's No. 2, behind Marriott International. When occupancy and room rates improved that it didn't much matter (I had supposed) that Starwood's wunder CEO, Barry Sternlicht, would spend nearly a year in a very public search for his successor. Long before, he had led the company's climb to most of the right places. Starwood raked in higher profits. The stock neared 60, from 38.

Missed opportunities like that I hate to see only thing worse? Not taking the time to do a long, hard look back

SHOULDA, WOULD, COULDA



Data: ComStock

like that I hate to see only thing worse? Not taking the time to do a long, hard look back

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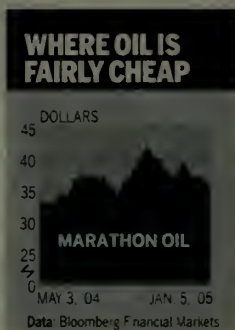


BY GENE G. MARCIAL

GO-GO OIL EXPLORATION MAY ATTRACT A BUYER AT MARATHON FOR WATCHMAKER MOVADO, THIS COULD BE THE RIGHT MINUTE WILL REFORM AT PRISON SUPPLIER CORNELL BRING A TAKEOVER

Marathon's Bright Flame

ALTHOUGH MARATHON OIL (MRO) has trailed its peers amid rising crude-oil prices, some pros say it's the play for the long run. Shares are down from 42 in May to 35.73 on Jan. 5, in part because of Marathon's bid to buy the 38% stake it doesn't yet own in a refining joint venture with Ashland Oil. Marathon, a world oil-and-gas explorer and producer, is also big in refining and marketing. Robert Lyon, president of Institutional Capital, which owns a 2.4% stake in Marathon, sees it as a "triple play that could deliver a home run." It has bright prospects in Libya, Russia, and West Africa; it is bound to get bigger in refining, where capacity is tight and demand strong; and it is attractive as a buyout target for ChevronTexaco or France's Total. Marathon would "fit like a glove" with ChevronTexaco, says Lyon. And Total, he adds, would profit from Marathon's refining capacity. Lyon, whose 12-month target for the stock is 50, figures Marathon would be worth more than 50 in a buyout. He reckons Marathon's oil reserves nearly doubled in 2004 and should rise substantially again in 2005. Lyon sees Marathon earning \$4 a share in 2005, vs. an estimated \$3.26 in 2004, and he believes the Ashland deal is favorable for the long term. Douglas Terreson of Morgan Stanley (which has done banking for Marathon), rates the stock "overweight" and says exploration operations in 2005-07 appear "strong, as projects in Angola, Equatorial Guinea, Norway, and even Ireland may materialize." ChevronTexaco and Total both declined comment.



Why Movado Is Ticking Right Along

NO MAJOR STREET ANALYST follows Movado Group (MOV), but a number of money managers are high on the watchmaker—pushing the stock up from 13.64 in August to 17.74 on Jan. 5. "It is still reasonably priced and a better buy than other luxury-goods stocks, such as Tiffany and Coach," says David Sowerby of Loomis Sayles, which owns shares. He notes that Movado's price-earnings ratio is 17, based on estimated earnings in fiscal 2005 ending Jan. 31—less than Tiffany's 21.5 or Coach's 29.2. Aside from its Movado, Concord, and Ebel watches, Movado also makes watches for Tommy

Hilfiger, ESQ, and Coach. Apparel designer Hugo Boss recently signed Movado to make "Hugo" and "Boss" watches. Susan Ng of Sidoti, a research boutique, who rates Movado a buy, says it is profiting from the luxury market's resurgence, which she says will continue to flourish. She sees earnings of \$1 a share in fiscal 2005 and \$1.15 in 2006, up from 92¢ in 2004.

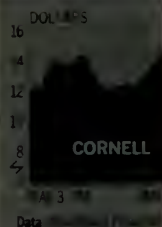
GETTING WOUND UP



Cornell May Be Poised For a Breakout

THERE'S UNREST at Cornell (CRN), a provider of operational services, including medical treatment and education, to 70 federal and local prisons in 13 states. Spearheading demand for reforms is Cornell's largest stakeholder, Pirate Capital, headed by Zachary George, who owns 14.5%. George says Cornell has been mismanaged, and he wants Chairman and CEO Harry Phillips Jr. to resign. Pirate's goal is to enhance shareholder value by selling the company. "Pirate continues to receive calls from strategic financial buyers interested in Cornell," says George in a 13-page filing with the Securities & Exchange Commission. Phillips has agreed to resign as CEO but remain as chairman and has started a search for a new chief. George insists Phillips should leave both posts. Cornell's stock has reacted favorably to the turmoil, leaping from 12 in May to 15.31 on Jan. 5. Sheryl Skolnick of Fulcrum Global Partners, who rates the stock a buy, figures it is worth 20 in a buyout. The company missed estimates in the past two years. The stock is up, explains Skolnick, because a takeover is imminent. Her earnings forecast: 48¢ share in 2004 and 71¢ in 2005, vs. 2003's 80¢. Pirate aims to submit its own slate of directors in order to sell the company. Cornell spokesman says the company has received offers but none has met the best interests of shareholders. ■

IT THRIVES ON TROUBLE



BusinessWeek online

Gene Marcial's Inside Wall Street is posted at businessweek.com/today.htm at 5 p.m. EST on the magazine's publication day, usually Thursdays.

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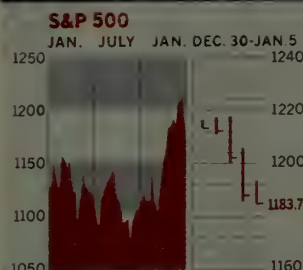
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STOCKS



COMMENTARY

Stocks rang in the new year on a weak note. The Standard & Poor's 500-stock index was down 2.4% for the week, the Dow Jones Industrials fell 2.1% and the Nasdaq dropped almost 4%. Sending stocks lower were year-end profit-taking and tax-loss selling. Disappointing U.S. employment numbers and construction spending didn't help matters.

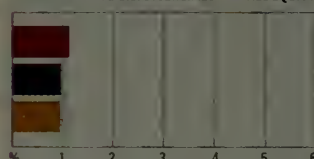
Data: Bloomberg Financial Markets, Reuters

MUTUAL FUNDS

4-WEEK TOTAL RETURN

WEEK ENDED JAN. 4

■ S&P 500 ■ U.S. DIVERSIFIED ■ ALL EQUITY



52-WEEK TOTAL RETURN

WEEK ENDED JAN. 4

■ S&P 500 ■ U.S. DIVERSIFIED ■ ALL EQUITY



Data: Standard & Poor's

U.S. MARKETS

	JAN 5	WEEK	% CHANGE YEAR TO DATE	LAST 12 MONTHS
S&P 500	1183.7	-2.4	-2.3	5.5
Dow Jones Industrials	10,597.8	-2.1	-1.7	0.5
NASDAQ Composite	2091.2	-3.9	-3.9	2.1
S&P MidCap 400	635.1	-4.2	-4.3	9.4
S&P SmallCap 600	312.0	-5.2	-5.1	14.0
DJ Wilshire 5000	11,611.8	-2.9	-2.8	6.5

SECTORS

	JAN 5	WEEK	% CHANGE YEAR TO DATE	LAST 12 MONTHS
BusinessWeek 50*	689.3	-2.3	10.8	10.4
BW Info Tech 100**	361.5	-2.9	3.1	0.2
S&P/BARRA Growth	569.0	-2.4	-2.2	1.4
S&P/BARRA Value	610.4	-2.5	-2.4	9.6
S&P Energy	276.7	-4.2	-4.1	21.5
S&P Financials	404.7	-1.5	-1.5	6.3
S&P REIT	135.5	-6.2	-6.2	17.1
S&P Transportation	235.0	-2.9	-2.7	16.7
S&P Utilities	137.4	-3.3	-3.0	16.1
GSTI Internet	167.4	-6.9	-6.1	11.7
PSE Technology	747.2	-4.0	-4.1	4.9

*Mar. 19, 1999=1000 **Feb. 7, 2000=1000

GLOBAL MARKETS

	JAN 5	WEEK	% CHANGE YEAR TO DATE
S&P Euro Plus (U.S. Dollar)	1362.2	-2.0	-2.5
London (FT-SE 100)	4806.0	-0.3	-0.2
Paris (CAC 40)	3829.4	0.1	0.2
Frankfurt (DAX)	4258.2	-0.1	0.1
Tokyo (NIKKEI 225)	11,437.5	0.5	-0.4
Hong Kong (Hang Seng)	13,764.4	-3.5	-3.3
Toronto (S&P/TSX Composite)	9021.1	-2.9	-2.4
Mexico City (IPC)	12,591.3	-2.3	-2.5

FUNDAMENTALS

	JAN 4	WEEK AGO
S&P 500 Dividend Yield	1.93%	1.93%
S&P 500 P/E Ratio (Trailing 12 mos.)	20.0	20.5
S&P 500 P/E Ratio (Next 12 mos.)*	16.1	17.0
First Call Earnings Surprise*	790%	2.48%

TECHNICAL INDICATORS

	JAN 4	WEEK AGO
S&P 500 200-day average	1129.8	1127.5
Stocks above 200-day average	76.0%	81.0%
Options: Put/call ratio	0.68	0.59
Insiders: Vickers NYSE Sell/buy ratio	6.34	NA

BEST-PERFORMING GROUPS

	LAST MONTH %		LAST 12 MONTHS %
Home Entertainment	12.7	Fertilizers & Ag. Chems.	75.0
Insurance Brokers	9.1	Internet Retail	71.1
Fertilizers & Ag. Chems.	8.1	Managed Health Care	54.3
Homebuilding	6.0	Internet Software	53.9
Managed Health Care	5.6	Wireless Services	51.4

WORST-PERFORMING GROUPS

	LAST MONTH %		LAST 12 MONTHS %
IT Consulting	-16.0	IT Consulting	
Electric Mfg. Svcs.	-12.0	Semiconductor Equip.	
Semiconductor Equip.	-10.7	Insurance Brokers	
Gold Mining	-10.2	Semiconductors	
Home Furnishings	-9.8	Electric Mfg. Svcs.	

EQUITY FUND CATEGORIES

4-WEEK TOTAL RETURN	%	52-WEEK TOTAL RETURN	%
LEADERS		LEADERS	
Latin America	4.1	Real Estate	28.6
Japan	4.0	Latin America	24.9
Health	2.7	Natural Resources	22.9
Diversified Pacific/Asia	2.6	Utilities	19.4
LAGGARDS		LAGGARDS	
Precious Metals	-5.3	Precious Metals	-14.8
Technology	-2.3	Technology	-4.5
Communications	0.1	Large-cap Growth	3.7
Natural Resources	0.2	Small-cap Growth	4.3

EQUITY FUNDS

4-WEEK TOTAL RETURN	%	52-WEEK TOTAL RETURN	%
LEADERS		LEADERS	
Perkins Opportunity	11.6	iShares MSCI Austria Idx.	62.5
Volumetric	11.6	PrFds. Mble. Tlcmms. Inv.	54.4
ProFunds Ultra Japan Inv.	11.2	Bruce	53.4
Delafield	11.2	Fidelity Sel. Mdcl. Del.	44.3
LAGGARDS		LAGGARDS	
Blue and White A	-9.7	ProFunds Semicdr. Inv.	-42.4
Commonwealth New Zealand	-9.5	Ameritor Investment	-41.2
ProFunds Pr. Mtls. Inv.	-9.4	Thurlo Growth	-35.0
Ameritor Investment	-9.1	Rydex Electronics Inv.	-28.5

INTEREST RATES

KEY RATES	JAN 5	WEEK AGO
Money Market Funds	1.76%	1.74%
90-Day Treasury Bills	2.32	2.26
2-Year Treasury Notes	3.20	3.18
10-Year Treasury Notes	4.28	4.32
30-Year Treasury Bonds	4.85	4.88
30-Year Fixed Mortgage†	5.74	5.69

*BanxQ

BLOOMBERG MUNI YIELD EQUIVALENTS

Taxable equivalent yields on AAA-rated, tax-exempt municipal bonds, assuming a 30% federal tax rate.

	10-YR. BOND	30-YR
General Obligations	3.19	6.19
Taxable Equivalent	5.19	6.19
Insured Revenue Bonds	3.19	6.19
Taxable Equivalent	5.33	6.19

THE WEEK AHEAD

INTERNATIONAL TRADE

Wednesday, Jan. 12, 8:30 a.m. EST » The November foreign trade deficit is forecast to have narrowed to \$53.4 billion, from a \$55.5 billion gap in October. That's based on the median forecast of economists surveyed by Action Economics LLC.

RETAIL SALES Thursday, Jan. 13, 8:30 a.m. EST » December retail sales probably jumped 0.7%, after a tepid November gain of

0.1%. Minus vehicles, sales most likely rose by 0.5% for a second straight month.

EXPORT-IMPORT PRICES

Thursday, Jan. 13, 8:30 a.m. EST » Export prices in December probably rose 0.3% for a second consecutive month. Import prices are expected to have fallen 0.4%, after a November gain of 0.2%.

PRODUCER PRICE INDEX Friday, Jan. 14, 8:30 a.m. EST » Producer prices probably nudged

up 0.2% in December, following a 0.5% surge in November. Excluding food and energy, core prices most likely grew by 0.2%, after a 0.2% rise in the prior period.

INDUSTRIAL PRODUCTION

Friday, Jan. 14, 9:15 a.m. EST » Industrial output very likely increased 0.4%, after expanding by 0.2% in November. The average operating rate probably moved up to 78.9%, from an upwardly revised level of 78.7% in November.

The *BusinessWeek* production rose to 236.6 for the week of Dec. 25, up 11.3% from the prior year. Before calculation of the week moving average, the climbed up to 239.3.

BusinessWeek on

For the BW50, more investment data, and the components of the production index visit www.businessweek.com/magazine/e

The Companies

index gives the starting page for a story or feature with significant reference to a company. Most subsidiaries indexed under their own names. Companies listed only in bold are not included.

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A Savings Crisis? Maybe Not

YOU HEAR IT ALL the time: Americans don't save enough. Foreigners warn that the government doesn't save enough to finance its budget deficits. Economists worry that consumers don't save enough to finance growth. The Bush Administration is framing the debate over Social Security privatization in terms of Americans not saving enough to retire.

Is the U.S. in a savings crisis? We think not, though one may be brewing if attitudes toward the budget deficit don't change in Washington. The fact is that for the past 20 years, America has grown faster than Europe and Japan, two of the world's highest savers. Year after year, U.S. deficits are financed, bills are paid, and living standards rise. If anything, America is awash in money. So where's the crisis? (page 34).

Part of the problem is simply measurement. When the U.S. government calculates savings, the official statistics count spending on education and research and development as "consumption," which is then subtracted from the country's savings rate. It makes little real-world sense. This spending is "investment" and should be a component of savings.

A far greater problem is conceptual. Conventional wisdom sees savings as a finite amount of money that is transformed into physical capital, investment, growth, profits, and jobs. Saving is about building factories and adding capacity. This

wisdom is out of date in an economy driven by human capital and innovation. Money spent on education, R&D, and innovation should be perceived as investing for the future. Fortunately, the U.S. still invests more in higher education—2.7% of gross domestic product—than other industrialized nations with higher savings rates. It is also among the largest spenders in R&D.

The savings rate fails to measure key investments in education and R&D

Conventional wisdom also holds that there is a limited amount of national savings, and each country has to husband it. Not so. Thanks to international markets and securitization, a vast and growing pool of savings flows from country to country, depending on investment opportunities, risks, and returns. And thanks to mortgage securitization, the housing market has been liquidated and is part of this global capital

pool. While the government doesn't count home equity as savings (another measurement problem), Americans do gain in housing and equities, and U.S. consumer net worth rose 8% in 2004, to a record \$50 trillion. Despite a low return, cash savings hit \$5 trillion last year, doubling in a decade. Corporations, too, are flush, with \$2 trillion on hand.

If there is a savings crisis, it resides in Washington. The forthcoming debate over Social Security privatization is really about savings. The danger is that in striving to increase a savings rate that isn't measured properly and matters less, the country borrows huge new sums, deepens the budget deficit, and undermines the confidence of global investors. We need to go beyond the traditional definition of saving to ask what policies will increase education and innovation in America. They are the true drivers of growth and prosperity.

Too Many Ways to Expense Options

WHAT HAVE WE wrought? Expensing stock options was supposed to provide a clear, consistent picture of earnings that can be compared across companies and industries. But that goal may now be fading. With a June deadline for expensing options, corporations are rushing to soften the expected hit to their bottom lines. They are each making very different decisions that threaten the consistency and comparability of earnings figures. While there were grievous corporate pay abuses in the '90s due to options, reform may prove as problematic as the original problem. The Financial

Accounting Standards Board should provide more guidance to make expensing options work. And auditors will have to speak up when they see bogus assumptions being made.

Putting a value on options, of course, is harder than calculating other compensation (page 32). You have to estimate future value, for example. By changing the assumptions underlying that estimate, companies can sharply reduce the expense. Take volatility. High-tech companies depend on options for a very high share of compensation. To lower the cost of expensing options, they are sharply reducing the assumed volatility of the underlying stock. While a case can be made for a secular decline in stock market volatility (the S&P 500 index traded in a very narrow range in 2004), one Silicon Valley company is cutting its volatility assumptions in half.

Others are reducing the life expectancy of options or cutting the duration of options from 10 to 7 or 6 years to lower estimated future value. Some are extending the vesting period. Others are vesting all options from previous years.

The good news is that the assumptions underlying option value are being made more obvious to investors. The bad news is that companies are going down many paths in expensing. There is no uniform accounting standard. We may be heading back to pro forma hell.

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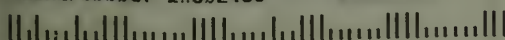
SOCIAL SECURITY

Are Private Accounts A Good Idea?

SPECIAL REPORT (P.64)



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NOT TO WORRY

Reassuring seniors is just part of the daunting Social Security-reform sales job facing Bush

Special Report Social Security

64 Are Private Accounts A Good Idea?

At the center of a Social Security-reform plan put forward by a Bush-appointed commission now being pushed by the President are personal accounts that would give Americans some control over their payroll savings. Bush isn't saying they're a panacea, but should they even be part of a Social Security solution?

72 The Beltway Battle Ahead

Social Security reform will be Bush's toughest legislative struggle to date and one he's determined to win. To get it off, he'll have to unite Republican

76 Sweet for the Street?

Financial firms may be excited by the potential fees from private accounts but they have good reasons for keeping a low profile

77 Commentary: Make 'Em Mandatory

Bush wants personal accounts to be voluntary. Nice populist move—but experience of other countries argue against it

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years of stagnation, the rugged d's lineup of sport-utility vehicles out to triple

ommentary: Airlines

's price cuts could finally trigger a awaited industry restructuring. will fall first?

llan Hubbard Has Heft, Too

President's choice to head up the onal Economic Council has more g for him than just loyalty

orporate Cases: Time to Cut a Deal?

ress may rewrite sentencing elines. At least in the short term, ould empower defendants

ommentary: A Greener Harvard

its highly paid money manager was n every penny

n Biz This Week

ernational siness

ermany: Turbocharging Siemens

Klaus Kleinfeld has shaped up sagging divisions. But as new he'll need to rev up the entire any and create a rival to match ral Electric

lectronics: Is LG the Next Samsung?

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China National Offshore Oil wants the California giant's vast reserves—even though its business has not gone well

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Unocal is paying millions to settle suits concerning forced labor in Burma. Will other multinationals be affected?

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Explorer still dominates, but tiny nonprofit Mozilla's latest browser is grabbing a chunk of market share from the software king

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When it came to our tasting of "white goods," the superpremiums ruled the day. Here, our top three in each category, plus our tasters' comments:

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Technology Special Report: Seven Trends for 2005

Though plenty of uncertainty remains, these developments promise to make the year memorable. Plus: Visit our redesigned Tech & Science channel. New features, more interactive, and easier to use



Morningstar Follows Google's Lead

The fund and stock researcher now says its long-delayed initial public offering will be an auction, similar to last year's IPO at the Internet search giant. The move should cheer individual investors and provide some good PR in the face of regulators' probes

The Economy: Good, Gloomy, Or Grim in the New Year?

Growth tops the wish list, says Standard & Poor's Chief Economist David Wyss, but even recession wouldn't be all that bad, given that recovery always follows. The big fear? Stagnation

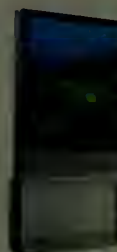


Can Toys 'R' Us Stay in the Game?

Speculation has swirled that the retailer will leave its namesake business in the face of stiff competition from the likes of Wal-Mart. If it remains in the toy biz after Babies 'R' Us goes independent, stores must become fun-filled destinations, especially for kids

What HDTV Is Missing: HD Content

Today's snazzy new sets are capable of showing pictures that are much better than those broadcasters and studios are yet providing



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"I wish I had a nickel for every time people have suggested that we do this."

—Steve Jobs, introducing Apple's first low-priced desktop, the \$499 Mac mini

D BY IRA SAGER

INSIGHT NEW REASON FOR FANNIE SQUIRM

FRANK BAKER is no friend of **Mae**—or the **Financial Accounting Standards Board**.

Recent win for this representative in a Capitol turf battle is giving a shiver to execs' spines mortgage—and giving to tech foes of option sing. cer chairs the



BAKER He's no fan of stock-option expensing, either

l markets subcommittee the House Financial es Committee. That has just wrested jurisdiction for accounting—including FASB

oversight—from the Energy & Commerce Committee.

The result: Baker gets a freer hand to try to thwart FASB's new rule requiring stock-option expensing. A Baker-sponsored bill passed the House last year but has stalled in the Senate. The bill would limit expensing to options granted to the top five execs and would exempt small companies.

Baker's new role also creates a tougher political landscape for Fannie, which has long used divide-and-conquer tactics to best its foes on the Hill.

With Baker firmly in command of all the issues involved in Fannie's \$9 billion earnings restatement, the mortgage giant's hot seat just got hotter. —Mike McNamee



CARDIN Luxury brands have said: "No thanks"

LICENSING

Ah Pierre, You Are So Everywhere

NOW THAT HE wants to retire, Pierre Cardin, the legendary designer who brought haute couture to a women's ready-to-wear line, is discovering the disadvantage of marketing to the masses. Cardin, 82, has been trying since 2002 to sell his clothing and accessories business, which he values at \$500 million. But big luxury-goods groups such as **LVMH Moët Hennessy Louis Vuitton** aren't biting.

These days, most luxury purveyors try to enhance their allure by controlling distribution—so that, for example, Gucci is sold only at its boutiques and a few upscale retailers. Cardin, by contrast, has licensed his name to more than 800 products, even socks and pens. "This brand needs a huge cleanup," says a source at LVMH. "There's no way we'd buy it."

Even so, Cardin's licenses still drive sales worth \$1.5 billion a year. Chinese manufacturers looking to add pizzazz to their apparel lines may be interested, speculates Milan luxury consultant Armando Branchini. Cardin's Paris office declined comment. But his Maxim's restaurant-and-hotel chain, also for sale, could itself fetch a few hundred million dollars. So Cardin needn't worry about retiring in luxury. —Carol Matlack

BIG PICTURE

GOOD CAUSE How do you pick among the charities requesting tsunami aid? Here are five ops graded on efficiency and effectiveness:

CHARITY	GRADE
AMERICAN RED CROSS	A+
HERAN WORLD RELIEF	A+
E THE CHILDREN	A-
JECT HOPE	B+
ECT RELIEF INTERNATIONAL	B

can Institute of Philanthropy

GADGETS

AUTOGRAPH HOUNDS, TAKE HEART

GLOBALIZATION has another discontent: Margaret Atwood. The author of such novels as *The Handmaid's Tale* and *Oryx and Crake* says



online book sales have created an impossible demand for name-brand authors to be promoting books in several places at once. "The book tour has turned into a global black hole of energy that ruins you," says the 63-year-old writer.

Atwood has a solution: a gizmo that allows authors to autograph books from afar. The contraption combines a Webcam, a tablet PC, and a robot arm that can hold any pen desired. Fans could go to a bookstore where the machine is in place, describe the desired inscription directly to the author through video ("Please write: 'To Mary, Happy Birthday, Margaret Atwood'"), watch as the author jots it out on her tablet PC—and see the robot arm duplicate the personalized message.

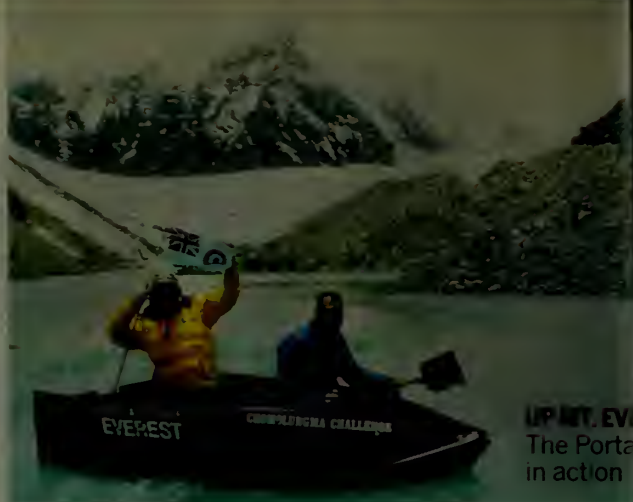
Atwood stresses that the device is still in the development phase. A prototype, which she put together along with some techie friends, was shown to

a recent gathering of about 60 publishing execs. The prototype uses a writing arm similar to an architectural plotter to sign books. Atwood hopes to have an improved model that uses a robotic arm available for a fall demo.

Ultimately she expects a coalition of financial backers, perhaps including publishers, and someone "who's more business-oriented than I" to run her newly formed company, **Unotchit**.

The apparatus should work to autograph a variety of products, Atwood notes: books, CD jackets, and T-shirts. But it may not be all-purpose. "I was once asked to autograph a belly," she muses. "I don't think it will work on bellies."

—Hardy Green



UP MT. EV.
The Porta-Bote in action

OUTDOORS

SEAWORTHY Of all the foldable things—snack tables, lawn chairs, fans—a boat isn't exactly the first thing that comes to mind. But last year Sandy Kaye, owner of Porta-Bote in Mountain View, Calif., sold nearly 10,000 dinghy-size boats for up to \$1,600 each. The boat folds to four inches in height and is made from a resin developed by NASA that gets stronger with each folding. With its flat design, the Porta-Bote fits on the side of an RV, the hull of a larger boat—or on a yak. Britain's Royal Air Force Mountain Rescue Service strapped it on to the scruffy animal for a trek up Mt. Everest and used it to cross a lake. The Porta-Bote may be the first vessel sold 20,000 feet above sea level. —Erin Chan

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FACE TIME

JULIA STEWART



MAPLE SYRUP WITH THAT POT ROAST?

IHOP, the \$400 million pancake chain, already owns a tall stack of America's breakfast business. Now it wants to gobble up more dinner dollars. On Jan. 13, CEO **Julia Stewart** unveiled the prototype for a new IHOP. The familiar blue A-frame roof remains, but there are also touches more conducive to evening dining, including softer lighting and new menu items such as portobello pot roast and charbroiled Atlantic salmon. The changes roll out to nearly 1,200 restaurants this spring. "We've been working on this for more than a year," she says.

Stewart, 49, worked as an IHOP waitress in high school in San Diego. She joined the company, based in Glendale, Calif., three years ago from Applebee's International, where she ran the U.S. unit. Stewart has shifted IHOP's business model from company financing of new stores to franchises only—and sales, stock price, and restaurant count have climbed steadily since. Looks as if she has found the right mix. —*Christopher Palmeri*

GADGETS

PLUG IN, TURN ON, FIGHT FAT

AN AVERAGE AMERICAN gains seven pounds from Thanksgiving to Christmas, and nearly 40% of us make losing weight our New Year's resolution, according to various polls. Yet a Jan. 4 study by the **University of Pennsylvania** found that most diet programs don't work. What are dieters to do?

You might want to try one of the dozens of products that wed two obsessions: dieting and gadgets. From lard-zapping ovens to caloric breath analyzers, here's a sample of the new weapons in the battle of the bulge. Be advised: Many of these have yet to be proved effective.

■ The Powerseed is like an electronic version of a watchful mom. The size and shape of an egg, it sits on the table and blinks every 30 seconds. That indicates that it's O.K. to take another bite, the idea being to eat more slowly and avoid overeating. Inventor Bill Curry has sold 1,000

ALL SHOOK UP

The appetite for weight-loss devices is insatiable

units online for \$49.95 each.

■ This summer, **Sharp Electronics** will unveil an oven it claims can reduce the fat content in food by turning water into steam heated to 500F. A combo of steam and heat cooks food and melts fat without losing moisture. Sharp says the oven is selling well in Japan and will cost \$1,399 in the U.S.

■ **HealtheTech** in Golden Colo., sells the \$179 **BodyGem**. The size of a soda can, it lets you breathe into a nebulizer piece. Then sensors figure out your oxygen intake and resting calorie-burning rate. Users can determine how many calories they can burn each day and how much they need to exercise to lose weight. —*Olga*

from \$667 million, or 71% of their total portfolio, to \$661 million in 2005, or just 55% of their yearly investments.

The main reason: It's tough to find good deals in the U.S., especially relative to emerging markets such as Eastern Europe. But Washington topped the survey as

the favorite U.S. city in which to invest. Why? The thesis is simple: Growing government will boost demand for space.

—*Brian Hindo*

REAL ESTATE

FOREIGNERS BACK OFF U.S. PROPERTIES

PROPERTY IN THE U.S. seems to have lost some luster for foreign investors. An **Association of Foreign Investors in Real Estate** survey of its 66 member firms—mostly European—shows that they expect to reduce new U.S. acquisitions

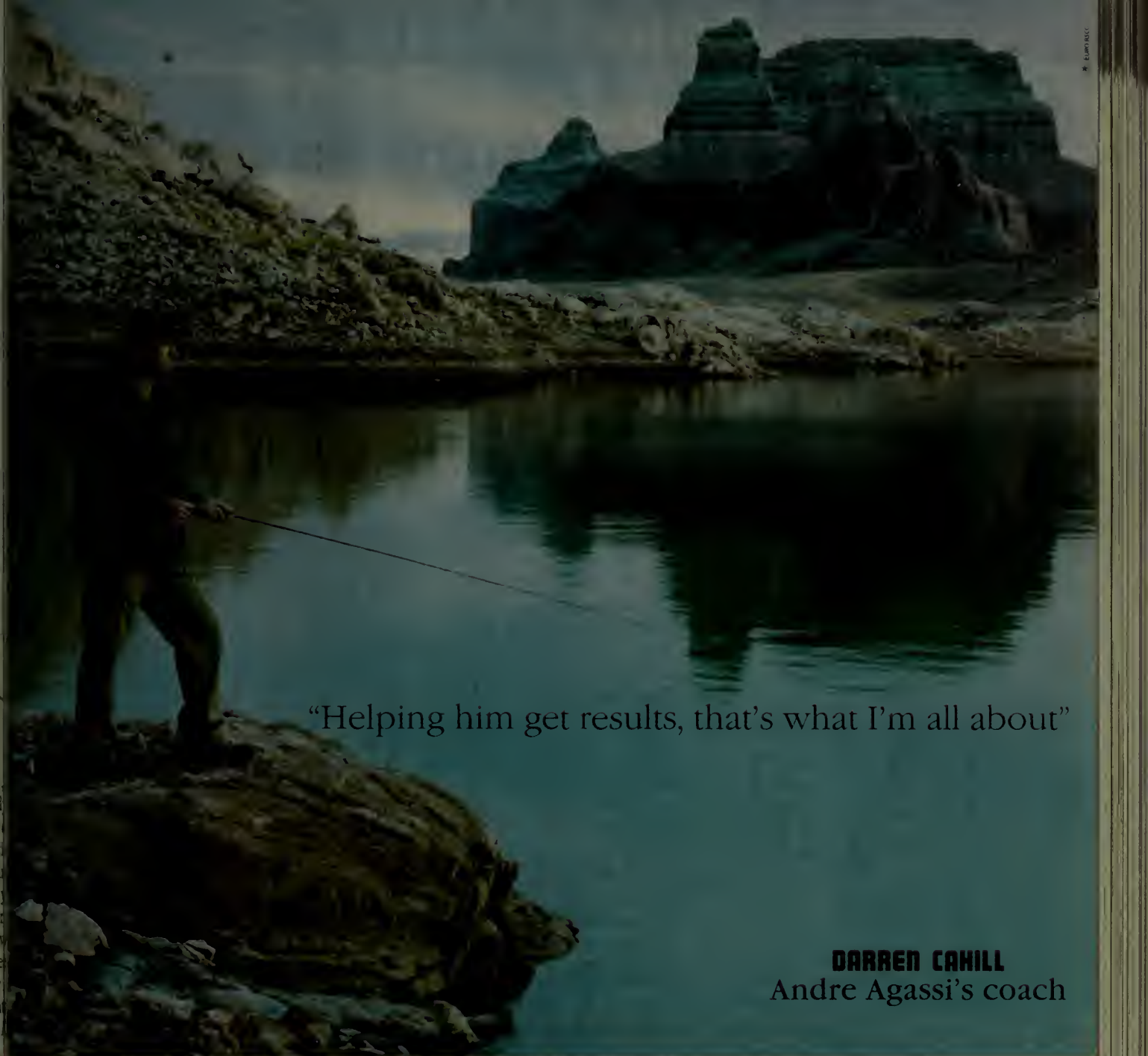


THE STAT

51

The percentage of employees who have confidence in their senior management. That's up from 44% in 2002.

Data: Watson Wyatt Worldwide



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Readers Report

I believe for the small guy that [the investment business] is a scam and that big investors manipulate the market."

*-Sheldon Ralston
Stratford, Wash.*



WAMP SOCIAL SECURITY? TWEAK 401(k)s AND IRAs

32, I AM worried about the solvency of Social Security. But it seems to me that they already offer similar retirement privation programs: 401(k)s and individual retirement accounts ("The Bush factor," *Entrepreneur*, Dec. 27-Jan. 3). While they are not mandatory, aren't they more in line with Bush's "Ownership Society" thinking? After all, you can choose how much to contribute, and you have thousands of options to invest in, vs. the few that may be offered should Bush's privatization plan become law. Wouldn't it make more sense to modify Social Security benefits and gradually raise the retirement age in conjunction with more 401(k) and IRA perks and incentives? Additional changes might allow early-withdrawal options for 401(k)s and IRAs to offset any increase in the minimum retirement age for Social Security.

In this way, Social Security remains a safe option with limited market risk for investors, yet people are encouraged to take control of their own financial future through increased private investment.

*-Jim Witkins
Madison, Wis.*

ALL BRICS CREATED EQUAL

DOUBT THERE IS an opportunity for investing in Brazil, Russia, India, and China (the BRICs). But you fail to mention the importance of property rights in evaluating private investment ("Four tries you must own," *Where to Invest*, Dec. 27-Jan. 3). In fact, weak property rights legislation is a common risk in these nations. In addition, it is important to highlight that these "developing nations" are in different stages of development. Compared with Russia, India, and China, Brazil is already in an advanced stage. Brazil has successfully made the transition from the military rule and hyperinflation of the 1980s. But high nomi-

nal and real interest rates are still an obstacle to be overcome. The BRICs should be treated like the individual entities they are when it comes time to invest.

*-João Coelho
Urbana, Ill.*

TO INVEST LIKE HARVARD, REMAIN SKEPTICAL

WITH ALL THE expertise gathered in *BusinessWeek*, no two alleged experts or selection methods suggest the same stock. Why not throw darts? But congratulations on having a sense of humor. In "How to invest like Harvard" (*Where to Invest*, Dec. 27-Jan. 3), CEO Jack R. Meyer of Harvard Management Co. flat out tells readers not to invest like Harvard. He suggests index funds. Harvard's single largest investment turns out to be timber, which it holds directly, avoiding messy commissions and commodity markets.

*-Perry Glasser
Haverhill, Mass.*

IN THE INTERVIEW with Harvard's Jack Meyer ("Husbanding that \$27 billion"), I liked his comment: "The investment business is a giant scam: It deletes billions of dollars every year in transaction costs and fees." I invested for 20 years with a large firm, and the original guard had ethics, in my opinion. Then they retired, and a younger group came in. All they wanted was trade, trade, trade. It was easy to tell they had no interest in my welfare. I eventually sold every stock and exited the investment field. I believe for the small guy that it is a scam and that big investors manipulate the market.

*-Sheldon Ralston
Stratford, Wash.*

TAKING THE HOUSE OUT OF HOUSEHOLD NET WORTH

IT SEEMS MISLEADING to add "home value" to the graph showing household net worth that accompanies "Consumers are piling on the presents" (*Business*



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Outlook, Dec. 27-Jan. 3). Trad measures of one's personal net wo clude equity in a primary residen good reason: You can't use the mo less you're prepared to sell your ho

Places such as Orlando are ha truly "exuberant" bubble, where are bought and sold several times construction is even complete. Fue such devices as "interest only" o negative amortization variable-i loans with low teaser rates, an i rate increase could send prices tun It would be wrong to say that so who has been living in his own Or area home has made or lost any mo the bubble runs its cycle.

—Robert S.
Lake Buena Vista

THE ILLUSTRIOUS ALFRED E. Ne no doubt has enough problems wi education Establishment without nessWeek's adding fuel to the fir Neuman does not say: "What me ry?" It's: "What, me worry?"

—Peter S.
Ston

IS CHINA AN 'ELEPHANT ON STEROIDS'?

IN "A NEW SINO-American econom U.S. could find itself undergoing the dian experience of "living next to a phant" ("The China price," Spec port, Dec. 6, and "How America can 'the China price,'" Editorials, Dec. our trade relationship, the U.S. is the inant partner. It can and does dictate (softwood, beef, pork, wheat, steel Still, Canada has been lucky. Althou have our differences—Iraq, the U.N. tilateralism, the role of government, care, etc.—we share history, languag culture. We are kinfolk. Natural pa We got rich together.

That won't be the case in a Sino- ican economy. Elephantine U.S. deficits suggest that China is a dominating the relationship, and Ar is in danger of becoming the junior ner. Worse, a Sino-American eco would be a partnership of strangers na would be an unsympathetic, even tile, elephant on steroids. I fear th and Canada will rue the day when v cided to sacrifice our comfortable, petent, and largely self-sufficient n al economies on the altar of globaliz

—Joseph Z.
Vancouve

I FEEL COMPELLED to contribute discussion under "Trading opi

People like Joan are the reason for an investment firm like ours.

RAYMOND JAMES

Joan Mira, 54, Attorney. Son Jordan attends private College in Chicago. Joan hopes to retire and open a coffee house. She'd like to call it Joan's Place.

RECTIONS & CLARIFICATIONS

"Cornell may be poised for a breakout" (side Wall Street, Jan. 17), Zachary George is an investment analyst at Pirate Capital LLC and not its head. Thomas Hudson Jr. is managing member of a firm.

Now the headline on "Auditors: The leash is shorter" (News: Analysis & Commentary, Dec. 27-Jan. 3), it was stated that accounting firms would no longer be allowed to perform tax services for companies they audit. Such services have been limited but not prohibited.

Why collectors are crazy for Chinese "Where to Invest, Dec. 27-Jan. 3), we reversed the dates of the Qing and Ming dynasties. Ming (1368-1644) preceded Qing (1644-1911).

at free trade" (Readers Report, Dec. 3, replying to "The China price," Editorial Report, Dec. 6). I have a couple of degrees in economics myself, and it has always been entertaining to read the diatribes of Third World economists who come to this country to lecture us on the evils of a subject so thoroughly misunderstood in their own cultures. Having gone beyond mere survival (where Third World economics ends), we in this country are more attuned to optimizing benefits by choosing among alternatives that do exist in the Indias and Bangladeshes of this world. To this extent, then, anyone preaching "free" trade is preaching to the 19th World choir.

We are making decisions right now that will change what has become a run-and-dash toward global free trade into something more measured. Open immigration, unrestricted economic warfare like H1-B, and "free" trade pacts and agreements will, hopefully, be evaluated not just on the basis of providing cheaper goods, but also by the impact (social and economic) they are having on those living in participating countries. For my part, the advantages have long since carried an acceptable social and national cost.

—Geoffrey K. Wascher
Utica, Mich.

THE GOP LED THE DEMS' BLUFF

BERT KUTTNER LAMENTS in "What I'd off the GOP deficit hawks?" (Economic Viewpoint, Dec. 27) that many have come to believe that "deficits don't matter." The supply-siders say we can grow

the economy out of debt, and the "starve-the-beast" advocates (e.g., Grover Norquist) believe high debt will eventually precipitate a crisis and force needed spending cuts. Kuttner claims "both things can't be true" and blasts the GOP factions for inconsistency. But he's wrong.

For decades, Democrats relied on GOP deficit hawks to clean up their messes, happy to take credit for the spending while blaming those sour Republicans for insisting on higher taxes. The GOP got wise to this game and, under Reagan, called the Dems' bluff. Here's the deal, they said. We're cutting taxes. If you keep spending at reasonable levels, we'll grow our way out of deficit and debt. If not, the coming crisis will force spending cuts.

Either way, taxes and spending are coming down. No inconsistency there, just a hard choice for Democrats!

—Steven P. Sawyer
Fountain Hills, Ariz.

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They're Watching You

NO PLACE TO HIDE

By Robert O'Harrow Jr.; Free Press; 348pp; \$26

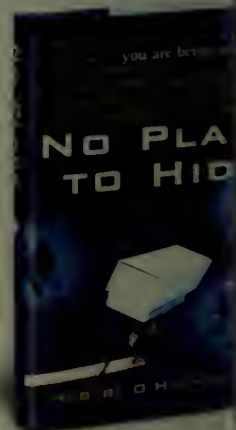
We appear to be on the brink of a post-September 11 surveillance society. In an optimistic scenario, the U.S. is employing its full range of technical ingenuity to ferret out terrorists, using all the resources of the Digital Age and its quirky software geniuses. Meanwhile, dazzling new biometric identifiers—

iris scans, voiceprints, DNA registries, and facial recognition software—are about to reduce identity theft to a quaint memory even while they shorten airport security lines and speed up credit approvals.

But in a less appealing second scenario, we could be on the verge of surrendering every detail about our private lives to an all-knowing Big Brother alliance of cops and mysterious private security corporations. They'll promise to protect us from terrorists. But along with that safety, we'll face arbitrary and unappealing decisions on who can fly in a commercial airliner, rent a car, borrow money, or even stay out of jail.

That's the conundrum at the center of *No Place to Hide*, a finely balanced look at the see-saw struggle between security and privacy. Author Robert O'Harrow Jr., a *Washington Post* reporter, deftly shows how the government and its contractors have been lurching between these two goals since the September 11 terrorist attacks raised homeland security to the public's top priority.

The biggest threat and the biggest promise seem to lie with official government databases but with the private companies that sell their information to all levels of government and to banks, airlines, credit-card companies, mortgage holders, car-rental agencies, and the like. You may not know much about ChoicePoint, Acxiom, Equifax, HSN Software, LexisNexus, or Seisint, but they have heard of you in more detail than you can imagine. Many of these companies, such as info giants Acxiom Corp. and Equifax, began by keeping track of such things as bankruptcies for credit-card vendors. But many of them are now able to provide lists of people who take Prozac for depression, buy in the Bible, gamble online, or buy sex toys. Another out-



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ains a 700,000-name list called "the Gay America
affile." And ChoicePoint, has more than 250 terabytes of
on 220 million people. If printed out, those records could
id to the moon and back 77 times.

ter September 11, it was only natural that these
panies would volunteer their services in tracking
rists. They had a head start in a critical technology: data
ng. In practical terms, that involves cross-indexing every
eivable source of information—unlisted telephone
bers, credit-card records, appliance warranty cards,
ranchise claims, arrest warrants, Social Security numbers,
custody orders, book purchases, E-ZPass records—to
ile a list of suspects or even possible terrorists that need
placed on the Homeland Security Dept.'s "no fly" list.
government has funded many of the efforts, among them
thing called Non-Obvious Relationship Awareness
(NORA), which can sift through billions of records and match
le with their home addresses, phone numbers, jobs,
ds, and other connections.

w public objections have been mounted to this commer-
ales activity. But when the Defense Dept. booted up a
ar program in January, 2002, it conjured visions of
ge Orwell's *1984* and attracted the attention of privacy-
scious members of Congress. Named Total Information
ness, the \$200 million Pentagon project proposed

the name heightened security, data miners may threaten civil liberties

constant scanning of all public
and private databases—
including financial, telephone,
and medical records—for signs
of suspicious activity. The
system would even be linked to
television cameras and low-
power radar to keep tabs on
individuals. It didn't help that
the head of the program,
Admiral John M. Poindexter, had
been indicted in 1988 for lying
to Congress about the Iran-
Contra affair. Once the press got
wind of the program, the
Pentagon bowed out.

ary, of course. But the private sector has managed to put
nooping to good use as well. ChoicePoint solved a series
opes in Philadelphia and Fort Collins, Colo., by mining
to get six likely suspects. Using a DNA database it owns,
ChoicePoint helped identify bone fragments at the World
Trade Center ruins. Seisint Inc., using a data-mining program
called Matrix, assisted the investigation into Washington's
Beltway Sniper shootings. The company directed police
to a house in Tacoma, Wash. There, in a tree in the backyard,
they found bullets matching those that had been used to
kill 16 people in and around the nation's capital. The two
suspects are now in prison. Also, soon after September 11,
ChoicePoint compiled a list of the 1,200 people it deemed the
greatest threats to the U.S. Five of the original hijackers turned
up on the list.

The successes of these private efforts help compensate for
government's too frequent ineptitude. But there are checks
and balances in government that simply don't exist in the
private sector. Private companies are keeping an electronic
log of our lives, "only we have no control over the diaries
and we can't even know what they say about us," concludes
Edward Snowden. "And there's no place to hide." ■

—By Paul Magnusson

Your data is 7 pounds, 3 ounces.



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BY STEPHEN H. WILDSTROM

On the Road To HDTV Paradise

Before last year's Super Bowl, I decided the time had come to upgrade to high-definition TV. It took me nearly until the start of this year's football playoffs to do the deed. I'm delighted with my HDTV, but the process of buying a display and setting up the service taught me that consumers still face a lot of pitfalls on the road to TV paradise.

My home TV room is small and would have been overwhelmed by one of the popular 40-inch plasma displays, so I settled for a 32-inch LCD. After much pondering, I chose the Sharp Aquos LC-32G4U, which I bought online for about \$2,800. (Prices climb quickly: A 37-inch version of the same set costs about \$900 more.) Two features drew me to the model. First, it doesn't contain a digital TV tuner—something you don't need if you have a cable set-top box, as I do. Second, all the wires from your cable box, a DVD player, and other devices run to a separate box that is connected to the display itself by a single fat cable. This makes it easier to hide the inevitable rat's nest of wires.

Those wires are something the consumer-electronics industry should do something about. With equipment you plug into computer networks, there are usually just two standard connections: one for power and one for data. My new TV has eight different types of audio and video connections. Several of these are dedicated to DVD players, which can connect to a display in various ways—and you, the viewer, have to figure out which is best. Simplification and standardization would help a lot.

CHOOSING A SOURCE OF HDTV CONTENT was easy. As a subscriber to Comcast's digital cable service, I knew from the program guide that a decent assortment of HD channels was available. Comcast offers a Motorola set-top box with a digital video recorder, welcome because my Replay TV unit can't handle HD. Although Comcast usually likes consumers to do their own installations, it insists on sending out a technician for HD because of the difficulty of choosing the right connections. The setup took a few minutes, and the new services add about \$7 a month to my already hefty cable bill.

Selecting HD programming is not a simple matter of turning on the set. Some cable channels, but not all, broadcast continuously in radiant color and clarity. On ESPN HD and Discovery HD, for example, images have a depth that good photographs and film deliver but that is lacking in standard TV. And the wide-screen format, which ESPN uses only part



There's a big do-it-yourself challenge with high definition

of the time, is particularly true in sports because it lets you see much more of the action.

Most network broadcast stations simulcast their regular programming on digital channels, and you learn quickly that digital is not necessarily better. Some of the content is true high definition, which means the picture consists of at least 720 rows of pixels, compared with standard TV's 480. But much of the programming looks about the same as analog broadcasts.

In fact, despite all the hype about digital TV, analog channels account for most of what you see on a digital cable system since analog shows weren't created for wide-screen viewing. There's a big do-it-yourself challenge. You must decide whether to watch with black bars on either side of the picture

or stretch the image to fill the wide screen, which makes the image short and fat. My Sharp also offers something called "smart stretch," which minimizes the distortion in the middle of the screen. For reasons I still don't understand, different shows look better in different formats, so you have to experiment.

In just a few years, the transition to digital TV will be complete, making things simpler for the viewer. And the industry will eventually find easier ways to connect gear. For now, HDTV is more challenging than it ought to be, but when it works, those beautiful images make the trouble and expense well worth it. ■

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BY ROBERT J. BARRO

How Tax Reform Drives Growth and Investment

Not since 1986, during President Ronald Reagan's second term, has the atmosphere in Washington been so promising for basic income-tax reform. Proposals are likely to include making permanent the tax changes of 2001 and 2003, flattening the tax-rate structure, and moving toward taxing consumption rather than income. The 2003 law gave a taste of what is to

come by advancing the effective date for the 2001 marginal tax-rate cuts and by reducing rates on dividends and capital gains. The 2003 tax cuts enhanced incentives for work effort, saving, and investment. So I think it is no accident that the U.S. has enjoyed rapid growth rates in gross domestic product, investment, and productivity since early 2003. Employment also grew, albeit with a lag.

Because the sharp cut in dividend taxation was a centerpiece of the 2003 law, it is particularly interesting to see how companies' dividend policies changed. The anecdotal evidence suggests a strong positive response, highlighted by Microsoft Corp.'s initiation of a regular dividend in 2003. Other large companies that started regular dividends in 2003-04 include Analog Devices, Best Buy, Clear Channel Communications, Costco, Guidant, Qualcomm, and Viacom.

A BROADER PICTURE COMES FROM the recent National Bureau of Economic Research working paper, "Dividend Taxes and Corporate Behavior: Evidence from the 2003 Dividend Tax Cut," by Raj Chetty and Emmanuel Saez, economics professors at the University of California at Berkeley. The Chetty-Saez study analyzes dividends paid by the universe of publicly listed corporations from the first quarter 1982 through the second quarter 2004. The sample, designed for statistical reasons to include the same number of companies in each period, comprises roughly the 4,000 largest companies by market capitalization in each quarter.

The study documents a surge in initiations of dividends after the dividend tax cut was proposed in January, 2003, and enacted in May, 2003. The percentage of companies in the sample that paid dividends increased from 20% in fourth quarter 2002 to 25% in second quarter 2004. This increased propensity to pay dividends reversed a long-term decline.

The 2003 reform was also followed by increases in payouts by dividend-paying companies. In the Chetty-Saez sample, the number of companies that raised regular dividends by at least 20% rose from 19 per quarter in the period before the tax reform was implemented to 50 in the postreform period. Another response was a surge in special, one-time dividends. This number rose from 7 per quarter pre-reform to 18 post-

reform. The most celebrated special dividend was Microsoft's payout of \$32 billion, announced in July, 2004.

The post-reform increases in dividends—new dividend initiations, larger dividends, and special dividends—still apply when Chetty and Saez control for profits, assets, market capitalization, and cash holdings. In other words, the tax reform made companies more likely to pay a dividend and to pay a larger dividend.

In addition, dividend initiations did not increase among companies for which the largest institutional investor was a pension fund or other entity not affected by the tax change. Neither did dividend initiations rise for Canadian companies, which are not affected by U.S. tax changes.

The dividend tax cut worked well. Companies boosted payouts

The study also revealed the relationship between the concentration of company ownership and the propensity to pay dividends. After the reform, dividend initiations were more likely if share ownership was heavily concentrated among executives or taxable institutions. The desire of these players to receive larger dividends when the tax rate falls is particularly likely to be translated into corporate dividend policy.

There's also evidence that the tax cut particularly heightened the propensity to pay dividends among companies with low forecasted earnings growth. So tax reform may have efficiently taken cash out of companies with below-average prospective returns on investment.

The dividend study shows that tax policy can have substantial and rapid effects on economic behavior. The study highlights the importance of the current deliberations on tax reform. The Bush Administration should seize the moment and deliver a tax system that promotes economic growth.

Robert J. Barro is a professor of economics at Harvard University and a senior fellow of the Hoover Institution (rjbweek@harvard.edu)

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Profits Should Stay Perfectly Presentable

...ce and productivity gains in 2005 may be enough to widen margins

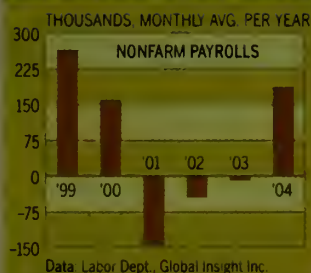
U.S. ECONOMY The fourth-quarter earnings season is just getting under way. Market professionals generally expect a solid 15% gain from the previous year in earnings per share for the 500 companies in Standard & Poor's 500-stock index. That showing would bring profit growth for the full year to about 20%. Such an increase is well

...of expectations at the beginning of 2004. But now we come to zero in on prospects for 2005. Both industry analysts and equity strategists expect earnings to slow considerably this year. Analysts, who tend to be the more upbeat of the two groups, look for a full-year gain of 10.5%, according to Thomson Financial. The strategists, who take a broader economic view, see a gain of only 6%. Neither would be a bad thing, especially in the fourth year of an economic recovery and given that 2004's stellar performance will present a tall hurdle for previous-year comparisons. What's behind the expected slowdown? The December report, with its gain of 157,000 new jobs last month, makes it clear that the labor markets are improving. And with productivity slowing, faster-rising unit labor costs begin to squeeze profit margins. At the same time, growth in overall earnings will be constrained by slower top-line revenue gains companies can generate this year when the growth rate for demand is expected to slow. That's the classic business-cycle pattern. But 2005 might be different. In fact, this year could be one in which both companies and workers enjoy more fully the benefits of improving economic growth. Productivity will be the key. As long as efficiency gains keep unit costs rising below price increases, then profit margins can expand, if only slightly. At the very least, they should hold steady.

THE RECESSION ENDED in 2001, businesses reaped the lion's share of the gains from the exceptionally strong uptrend in productivity. Profits soared, while job and income growth remained lackluster. But 2004 signaled a change in that pattern. Hiring picked up, as did income growth from wages and benefits. The resulting higher labor costs—along with the expected jumps in oil and commodity prices—meant the pace of corporate profits slowed. But thanks to solid gains in productivity, margins remained high last year, and earnings consistently beat expectations. The Labor Dept. has not yet reported on fourth-quarter productivity, but given the expectations for about 3.5% growth and a 2% gain in hours worked, as shown in the latest jobs report, the fourth-quarter productivity

increase was probably in the range of 1.5%. If so, output per hour managed to grow at a healthy clip just above 2.5% from the end of 2003 to the end of 2004. That's less than half the spectacular 5.7% pace posted during 2003, but productivity typically slows when a recovery gains traction. Plus, the 2004 pace is close to productivity's long-term growth trend, generally estimated to be about 2.5%.

2004 JOB GROWTH: THE BEST IN FIVE YEARS



Even with the advance in productivity, the economy was able to create 2.2 million new jobs last year, or about 186,000 slots per month, the best showing since 1999 (chart). That performance is disappointing only in the context of past job cycles. In the period of just over three years since the 2001

recession ended, payrolls have risen only 1%, compared with 4.6% during the "jobless recovery" after the 1990-91 recession and an 11.1% surge after the 1981-82 downturn.

IN 2005 PRODUCTIVITY GAINS, while clearly cooling, are not likely to fall as sharply as they have at this stage of past recoveries. Previously, it was not unusual for productivity to actually decline for a period as businesses were willing to add workers in anticipation of coming demand growth. But in today's economy, companies remain fixated on using greater efficiency as a means to hold the line on costs and lift profits and shareholder value in an extremely competitive global marketplace. Those pressures will remain in place this year, if not intensify. Indeed, foreign trade remains an obstacle to growth for the U.S., as the huge widening in the November trade gap showed (page 30).

Equally important, global competition as well as the technology revolution have altered Corporate America's mindset regarding productivity and hiring. As a result, the job cycle has changed, perhaps forever. The days when employment gains averaged more than 300,000

per month, as they did in 1994, are gone. But keep in mind that last year's job growth was still strong enough to support healthy income advances. In December average hourly wages for production and nonsupervisory workers were up by 2.7% from the previous year. That's a much better showing than the cycle-low of just 1.6% in February (chart).

In 2005, given the expectations for 3.5%-to-4% economic growth, along with 2% productivity growth, payrolls should increase in the neighborhood of last year's clip. Based on historical relationships, the pace should be sufficient to lower the jobless rate to about 5%, from 5.4% in December, 2004, and it will create enough new income to support a 3% or so rise in consumer spending.

An improving climate for workers doesn't mean profits have to take it on the chin. The economy showed considerable momentum heading into 2005. December's purchasing managers' surveys for both the factory and nonmanufacturing sectors suggested a firmer tone among businesses. Also, consumer spending surpassed expectations. Strong December car sales and post-Christmas buying imply that real household outlays grew at an annual rate of about 4% last quarter. The profits outlook will be enhanced if either economic growth or pricing power outperform expectations this year.

IT'S EASY TO construct a scenario, using conservative assumptions, in which profit margins could actually expand a bit further in 2005. With slack in the labor

markets being taken up very slowly, workers' wages and benefits this year are unlikely to grow much faster than their pace of about 4% in 2004. Wages will pick up as the pace of benefits should slow as they did last year when health-care costs began to cool.

If productivity rises 2%, a 4% gain in compensation means the cost of labor to produce a unit of output, on average, will rise 2%. Prices are widely expected to rise in the 2%-to-3% range. A gain above 2% would result in wider profit margins on each unit of output.

In addition, profits will be helped by the weaker greenback, foreign-based earnings

U.S. multinationals are translated into dollars.

Without a doubt, corporate earnings in 2005 will match their consistent outperformance of 2004. In the first quarter of last year, 73% of company reports beat expectations, followed by 67% in the second quarter, 62% in the third, according to Thomson Financial. Given the sharply lower expectations for 2005 and the continuing potential for additional margin expansion, there may well be some room for a few upside surprises this year, too. ■

WAGE GROWTH MAKES A COMEBACK



INTERNATIONAL TRADE

Why the U.S. Deficit Is Stubbornly Huge

THE U.S. TRADE GAP for November was a shocker. After the October deficit had widened by a huge \$5.1 billion to \$56 billion, many economists had expected the deficit to narrow slightly, especially with the dollar declining and oil prices beginning to retreat. Surprise! The November deficit jumped another \$4.3 billion, to a record \$60.3 billion.

The latest data refocus attention on the intractable nature of the U.S. trade problem. U.S. imports are 50% greater than U.S. exports, so shipments abroad have to grow far faster than imports just to stop the deficit from widening. But in November, real imports of goods were up 12.1% from the previous year, while

exports were up only 1.2% (chart).

True, the 16% drop in the broad trade-weighted dollar since its peak in early 2002 is making U.S. exports more competitive overseas. But the benefits of a lower dollar are being overwhelmed by weak foreign growth, especially in Europe. At the same time, strong U.S. demand continues to bring in more imports.

Equally important, the dollar's decline has not been evenly distributed. The greenback has fallen significantly vs. the euro and yen, but the major-currency countries account for less than half of the volume of U.S. trade. Compared with early-2002 rates, the dollar is still up 2.5% against a basket of currencies from countries that

make up 40% of U.S. trade volume.

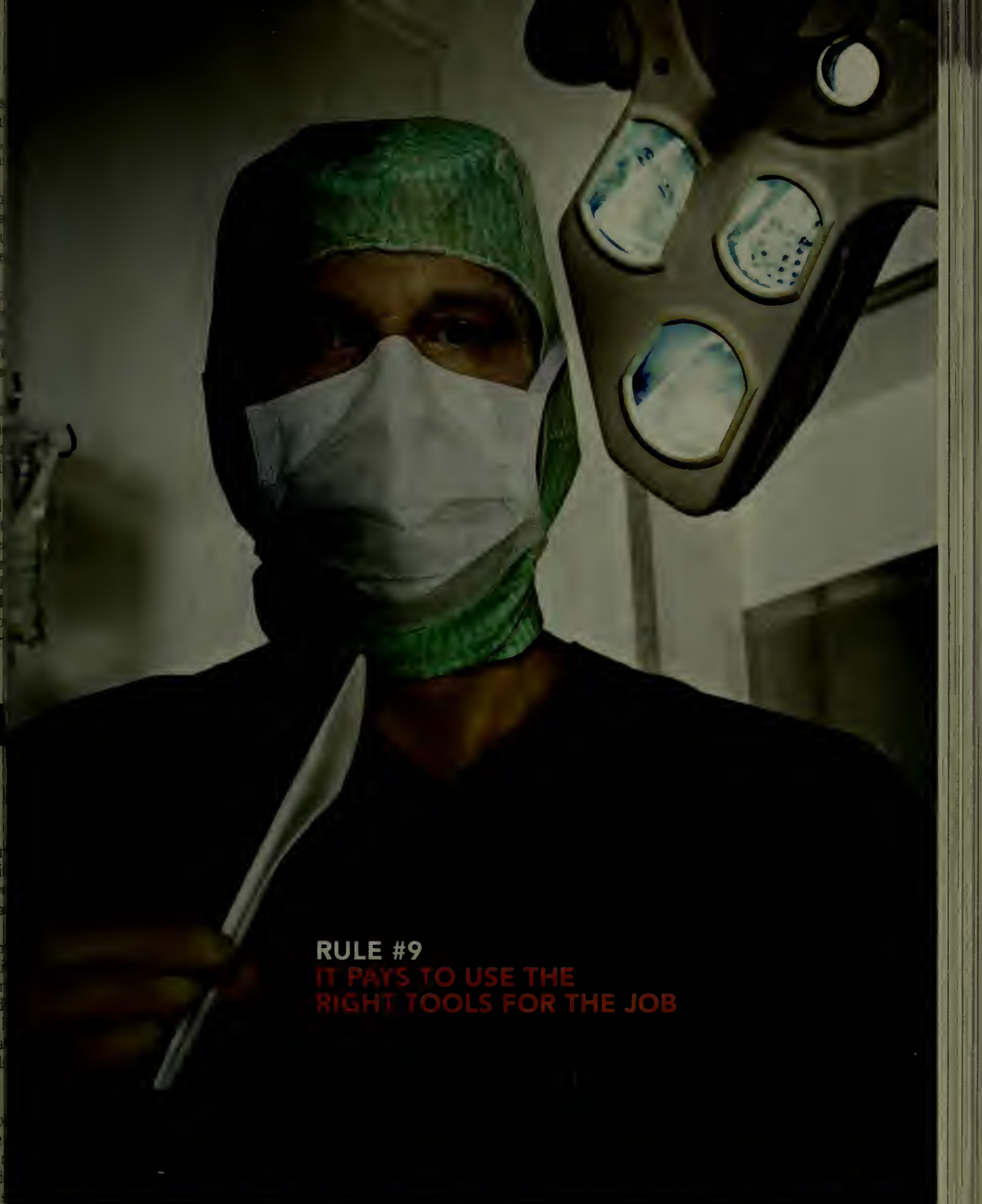
China, in particular, is using its surging foreign exchange reserves to keep the yuan cheap. According to *The Asian Wall Street Journal*, China boosted its reserves by \$207 billion last year, to \$609.9 billion. Given such currency pegs, it's no wonder that, while nonoil import prices increased 3.4% over the past year, they haven't risen at all for goods coming from Asia's newly industrializing economies.

The most immediate impact of the November trade surprise will be on U.S. economic growth. Without improvement in the December deficit, trade is set to subtract, by itself, 1.5 percentage points from growth in real gross domestic product.

What the November report shows is that a lower dollar, by itself, will be a cure-all. Faster world growth in 2005 will be needed as well. ■

IMPORTS STILL FAR OUTPACE EXPORTS





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JOBS "I think we're going to bring in a lot of new customers"

GH TECH

APPLE'S BOLD SWIM DOWNSTREAM

The master of high-end style is bringing out two products aimed at the average Joe: The \$499 Mac mini PC and the \$99 iPod shuffle

APPLE COMPUTER INC. CEO Steven P. Jobs always has gobs of new products to unveil to the Mac faithful at the Macworld trade show each January, and this year he showed up with a more startling bag of tricks than usual. The company that has become synonymous with high-end style computers and music players unveiled not one but two new products aimed at the mainstream. Making clear aim at the low end of its core markets, Jobs first announced the Mac mini, an impossibly small \$499 PC that is Apple's first entry into the sub-\$1,000 market that now accounts for almost 70% of all home PC sales. Then he unveiled the iPod shuffle, which is

smaller than a pack of Wrigley's gum and starts at just \$99—a far cry from the \$249 the Cupertino (Calif.) company now gets for its cheapest music player, the iPod mini. “I think we’re going to bring in a lot of new customers to Apple,” said Jobs in a post-keynote interview, his iPod shuffle draped on its lanyard around his neck.

RIDING HIGH

THE PACKED HOUSE of Macolytes loved it—and most analysts are applauding as well. Still, the new strategy is not without risk. Chief among the fears: that by moving into crowded entry-level sectors, Apple could cannibalize its higher-priced products, putting at risk the strong profits it needs to finance innovation. Jobs's shift comes even as many analysts were expecting the company to gain PC market

share in 2005 for the first time in years—without having to stray from its more lucrative high-end niche. “Some people will ask: Should they have left well enough alone?” says First Albany Capital Inc. analyst Joel Wagonfeld.

Clearly, Jobs & Co. believe the time is right to broaden out: Thanks to the phenomenal popularity of the iPod, the company is riding high. On Jan. 12, Apple announced that its fiscal first-quarter net earnings quadrupled, to \$295 million, over the previous year, on revenues up 74%, to \$3.49 billion. Sales of the red-hot iPod alone hit 4.5 million units, a 500% increase. Apple also sold 26% more computers than it did during the same period a year ago. Those numbers sent Apple's shares soaring in after-hours trading.

Crucially, many of the folks who

bought the music player last quarter are Windows users. With iPod mania running full tilt, Jobs figures there's an opening to grab PC market share by drawing in users who want Apple's famous style and ease-of-use. Until now, Apple products have been too expensive for most PC users, but Jobs is betting that the \$499 mini could make Apple a viable contender at the core of the market. To simplify things even further, Apple made sure PC users can plug their existing display, keyboard, and mouse into the unit. "This is the most affordable Mac ever," Jobs told the crowd. "People who are thinking of switching will have no more excuses."

Low cost isn't the only lure. Jobs is also betting that once PC users finally get a chance to use Apple's highly regarded operating system and software suites, there'll be no turning back. The deluge of viruses and spyware targeted at Windows has reached such a pitch, Jobs figures, that people will be ready to embrace Apple's relatively safe OS. Apple intends to press its software advantage hard: While Jobs devoted a few minutes of his two-hour speech at Macworld to the Mac mini, he spent most of the speech extolling the Mac OS and the latest iteration of Apple's iLife software suite, which makes it easier than ever for users to manage photos, music, and video.

Jobs may have hit upon a winning strategy. Just ask Michael Wood. Having already fallen hard for his wife's iPod and intrigued by a \$499 Macintosh computer, the Shelby (N.C.) auto salesman is now considering a Mac. Citigroup Smith Barney analyst Richard Gardner expects the mini could double Apple's market share in PCs, to 4%. That may not sound like much, but it would translate into an extra \$4 billion in revenues for Apple.

UNDERCUTTING

WHAT ABOUT the iPod shuffle? Having dominated the hard-drive segment of the digital music-player market, Apple is ready to take a run at cheaper players that use flash memory. Now that market is fragmented among dozens of players that charge roughly \$150 for devices that hold 120 songs.

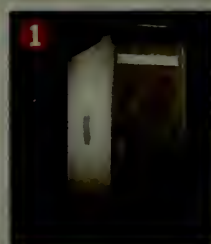
What Jobs has done is deliberately undercut the competition. The base model of the new shuffle costs \$99 and holds 120-plus songs. To get to that low price, however, he has designed a bare-bones player that may not appeal to everyone. Unlike many other flash players, Apple's gadget boasts no screen—meaning users can't see or control what they're playing.

Apple is betting that there are plenty of

NEW APPLES IN THE ORCHARD

Apple has stuck to upmarket products in recent years, squeezing maximum profit from die-hard fans. Now it hopes to build on the iPod's success by going more mass-market in two promising growth areas: Home PCs and low-end music players. How the new Mac mini and iPod shuffle fit into the lineup:

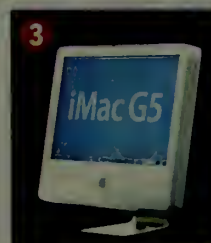
PCs



1. POWERMAC G5 Apple's most powerful computer is aimed at corporate creative types—many of whom have moved to Windows PCs in recent years
\$1,500-\$3,000*



2. POWERBOOK G4 Thanks in part to the iPod "halo affect," this powerful notebook is popular among students
\$1,600-\$2,800



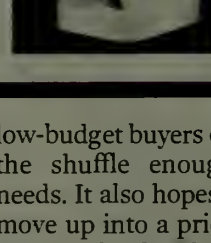
3. IMAC G5 Introduced last fall, the all-in-one flat-panel machine won raves, but it's too costly for most consumers
\$1,300-\$1,900



4. IBOOK G4 The rugged notebook is targeted at budget-conscious schools and consumers
\$1,000-\$1,500



5. eMAC This budget-price all-in-one machine is the choice for many schools
\$800-\$1,000



6. MAC MINI With its new low-priced contender, Apple hopes to lure unhappy Windows PC owners
\$500-\$600**

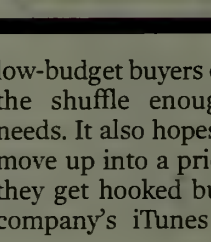
MUSIC PLAYERS



1. IPOD PHOTO Designed to store images as well as tunes, sales have lagged other iPods since its debut in October
\$500



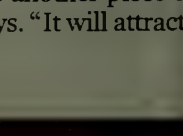
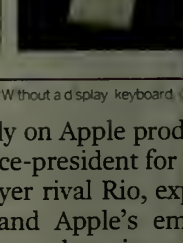
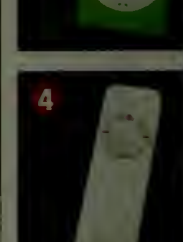
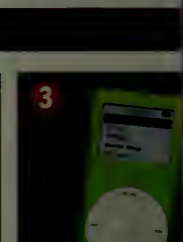
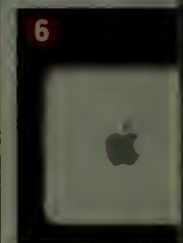
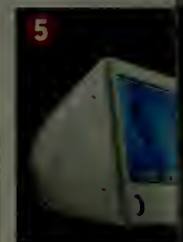
2. IPOD Apple's best-selling product hooks music fans who want a device to hold their entire music collections
\$300-\$400



3. IPOD MINI Capable of storing 1,000 songs, its lower price and smaller size have made it popular with the gym set
\$250



4. IPOD SHUFFLE A simple, inexpensive device for folks who need to carry around only a dozen or so CDs' worth of music
\$100-\$150



low-budget buyers out there who will find the shuffle enough gadget for their needs. It also hopes they'll be tempted to move up into a pricier iPod, especially if they get hooked buying music from the company's iTunes Music Store, which

currently plays solely on Apple prod Even Dan Torres, vice-president for keting at music player rival Rio, ex the shuffle to expand Apple's em "This is going to be another piece o pie for them," he says. "It will attract

*Without a display **Without a display keyboard

omers—and be the third or fourth for many [existing customers].” But couldn’t the cheaper products tempt some customers to shun the high-priced ones? For example, the hordes of people who bought iPods as gifts this year will be content to get that favorite niece a pricey shuffle next year. Apple has done what it can to prevent that from happening by segmenting its lineup. With its greater storage and better controls, the original iPod is a very different gadget from the shuffle. Likewise, Jobs, who has gotten off fears of cannibalization, has been sure the new mini lacks the power and many features found in the iMac and the company’s higher-priced computers.

IT SIMPLE

Apple will have to tread carefully as it enters the low end of the PC market. It is to avoid succumbing to the prosperity that has dogged so many others. After all, only Dell makes consistent profits these days in this business, and it’s a very efficient manufacturer.

To beat the odds, Apple will keep its prices low so it can maintain its profit margin and thereby have the resources to keep innovating. That’s one reason, analysts say, that the company has opted to make its new products simple, with fewer expensive components. The iPod shuffle lacks a hard drive, enabling Apple to benefit from tanking prices for flash memory. The Mac mini has a slower chip with less storage than Apple’s pricier machines. And leaving out the display, keyboard, and mouse cuts costs even further. The upshot: Smith Barney’s Gardner says Apple should churn out 15% gross margins for the mini, about what it gets on the iMac G5. And because Apple has already paid for the Mac operating system in its retail stores, says Gardner, nearly every gross profit dollar the mini generates will drop to the bottom line.

At the end of the day, most analysts think Jobs has played his cards shrewdly. If cannibalization gets too severe or margins too tight, Apple could back away from the low end. Indeed, the company seems to be probing somewhat tentatively. For an outlet that typically hypes its new hardware to the heavens, Jobs is notably low-key when it comes to the Mac mini. Nor is he preaching an overnight market share grab. “I have our ideas about how many we can sell, but it’ll be either too few or too many,” he says. “I’ll know in a month or so. Either way, it’s not likely to end the times in Cupertino. ■

—By Peter Burrows in San Francisco, with Andrew Park in Charlotte, N.C.

CHIPS

How Intel Ruined AMD's Happy New Year

For chipmaker Advanced Micro Devices Inc. and CEO Hector Ruiz, 2004 was something of a coming-out year. Long a perennial also-ran to Intel Corp. in the semiconductor market, AMD knocked its mighty rival back on its heels last year with an innovative microprocessor for servers and personal computers. The company swiped market share from Intel, raked in cash, and saw its stock soar. *BusinessWeek* even named Ruiz one of the best managers of the year.

In the tech industry, though, you’re only as good as your last earnings announcement. On Jan. 10, AMD warned that fierce competition in the memory-chip market would push fourth-quarter earnings well below Wall Street

expectations. In a tersely worded release the Sunnyvale (Calif.) company said it expects fourth-quarter operating income to be “down significantly” from the third quarter. The stock plunged 26% the next day, to \$14.86. The misstep fanned fears that AMD, for all of its success in 2004, remains the same inconsistent performer it has been in the past, with solid results followed by spectacular washouts.

What happened? Intel lowered the boom. The chip giant got much more aggressive in the market for flash-memory chips, which store data in cell phones and other electronic devices. That contributed to a 30% decline in flash prices in the second half of the year. Such a drop hurts AMD much more than Intel because the smaller chipmaker gets nearly 50% of its revenues from flash-memory chips, while Intel gets only 7%. As if to underscore the giant’s advantage, the day after AMD’s warning, Intel announced strong results for its fourth quarter. “AMD’s head has got to be spinning. Intel just clocked them good,” says analyst Richard L. Whittington at researcher Caris & Co., one of the six

firms that downgraded AMD’s stock on the news.

Ruiz may have a tough time clearing his head right away. Even as growth in the flash market slows this year, Intel vows to keep competing aggressively. That’s likely to put a crimp in prices and limit AMD’s ability to take back market share. In the third quarter, Intel grabbed the lead in the flash market, with 22.9% share, compared with

22% for AMD, according to researcher iSuppli Corp. “In six months’ time I would be very disappointed if we didn’t show continued momentum,” says Sean M. Maloney, the Intel executive vice-president who oversees the business.

There’s no question that Ruiz has AMD on much more stable footing than in the past. Unlike in the aftermath of



RUIZ He must diversify quickly

previous setbacks, analysts believe the chipmaker will continue to turn a profit. Consensus estimates call for 2005 net income of \$217 million on sales of \$5.24 billion. Ruiz also is racing to wean AMD away from its reliance on the cyclical memory-chip business. He’s expanding into the sale of chips for consumer electronics and plans to roll out a new processor for the notebook market, which is dominated by Intel now. And he hopes to bring a huge new manufacturing plant online next year to relieve the manufacturing constraints that have stymied the company’s growth. Still, AMD is likely to have to depend on the volatile flash market for at least a third of its revenues for the next two years.

In the end, Ruiz knows it will be customers who decide AMD’s fate. At the Consumer Electronics Show in early January, he greeted them by the dozens as waiters plied them with drinks and hors d’oeuvres at a posh restaurant. One thing is clear: This battle is just beginning.

—By Cliff Edwards in San Mateo, Calif., with Spencer Ante in New York

COMMENTARY

BY STEVE HAMM

One Way to Hammer at Windows

IBM's open-source support is a deft attempt to undermine Microsoft's market

BIG BLUE COLLECTS about \$1 billion a year in licensing fees from its hoard of 40,000 patents. So it came as quite a surprise to some on Jan. 11 when IBM pledged to make 500 of its software patents, valued at about \$10 million, freely available to open-source software projects such as the Linux operating system and the Apache Web page server software. Why would IBM allow others to use its intellectual property free of charge?

In a word: Microsoft. The move is central to IBM's efforts to fend off Microsoft Corp. and its Windows monopoly. While the computing giant will continue to innovate and gather new patents as aggressively as ever, at the same time it is stepping up efforts to bolster the world of open-source software. IBM figures that doing so will give it a leg up in selling the software and services that work with the open-source programs it helped develop. And that in turn should help it gain an edge against its Redmond (Wash.)-based rival. "They're poking their thumb in Microsoft's eye," says Alfred S. Chuang, chief executive of software maker BEA Systems Inc., a competitor of both tech giants.

It's striking how different IBM's strategy is from Microsoft's. Microsoft, which declined to comment, is building a legal team to enforce intellectual property claims. In so doing, it hopes to protect its monopoly: When makers sell PCs and servers loaded with Windows, Microsoft has the best shot at selling an array of applications.

IBM has a different tack. In a strategy it calls "collaborative innovation," it shares some of its intellectual property, hoping to bolster open-source alternatives to Windows, such as Linux. Such programs are shared by thousands of companies and tens of thousands of programmers. "It's a blending of both worlds, a balancing of proprietary and open technologies," says Jim Stallings, IBM's vice-president of standards and intellectual property. It helps IBM create a non-Microsoft ecosystem. By selling a server with Linux, IBM boosts chances of selling databases, application integration software, and services. Big Blue is also creating



STALLINGS IBM is helping to build a non-Microsoft ecosystem

the best-known examples, and both become market share leaders. But companies are also embracing a host of other applications, including software for manufacturing databases and writing custom programs.

Not only do companies typically pay less for open-source software than for traditional software; they're also less likely to be locked in by any one tech supplier, Microsoft or IBM. "I can't tell you the countless billions of dollars that have been spent replacing closed technology," says Kevin Souza, an engineer at Raytheon Co., which uses some open-source software. "You install [proprietary] software and you get dependent on the vendor's hardware line or on somebody's operating system."

IBM hopes its move will spur others to contribute patents to an "intellectual property commons." The 500 patents cover categories, from storage management and e-commerce to data processing. They're not aimed at specific open-source projects; the idea is to give entrepreneurs and companies free rein.

Tech companies have already pitched in key pieces of technology for open-source projects. IBM spent more than \$1 billion bolstering Linux and donated its Cloudscape database, valued at \$85 million, and Eclipse software development tools, valued at \$40 million. Sun Microsystems Inc. handed over a set of desktop applications, now called OpenOffice, which is an alternative to Microsoft's pricey Office suite.

It's harder for tech companies to make a buck in the open-source world, but IBM feels it has no choice but to forge ahead. Better to give up a little—and potentially gain a lot more in the ending battle with Microsoft. ■

"innovation network," says analyst Navraj Kapur, a former Microsoft executive and now a senior advisor at Forrester Research Inc. "No company can have all the answers. They need to rely on themselves and all the innovators. They need partners."

IBM, not Microsoft, seems to have the advantage at its back. Increasingly, info tech managers are using open-source programs as trusted building blocks for critical computing systems, including Apache, which serves up Web pages.

Open source prevents companies from having to rely on one supplier



ZETSCHE IN DETROIT

The Hurricane concept car is a takeoff on the dune buggy

EXTREME MAKEOVERS

AN JEEP BUST OUT OF ITS RUT?

After years of stagnation, the rugged brand is about to double its lineup

CROWDS AT THE DETROIT auto show on Jan. 9 got a few hints about Jeep's future when Chrysler Chief Executive Dieter Zetsche helped tug the covers off a pair of concept vehicles.

The wacky, dune-buggiesque Hurricane says that nothing is sacred in Jeep's effort to assault new SUV turf. And the raucous, in-your-face Gladiator sport-utility concept aims to remind consumers of Jeep's battlefield cred, stretching back to WWII Willys Jeep, and to wrest back the macho-military mantle from General Motors Corp.'s Hummer.

It's all part of DaimlerChrysler's plans to rev up the Jeep brand. Having already brought Chrysler back on the road to prosperity with popular new cars and minivans, the German-U.S. giant sees the potent Jeep brand as the next obvious place to boost sales. Over the next three years, it will more than double Jeep's lineup, launching a rugged people-hauler, and a couple of smaller, car-like models. Two years ago, the company vowed to build the group's sales by 10 million units in a decade. Says the

CEO: "Jeep is an important part of that."

No doubt Jeep has room to grow. However, to help meet Zetsche's target, the brand faces big challenges. By offering up smoother-riding, car-like models, Jeep runs the risk of muddying its rough-and-ready rock-crawler image. Then there is the danger that the SUV wave has crested; gas-guzzling behemoths are losing sales and require big rebates.

Jeep has a lot of catching up to do. Since 1992's launch of its wildly popular Grand Cherokee mid-size SUV, 45 new sport-utes have joined the field. Jeep grabbed nearly 30% of the SUV market a decade ago, with sales of roughly 408,000 Jeeps spread across three models. The SUV market has since doubled to 2.8 million vehicles a year, but last year Jeep sales just topped 427,000 units, for a 15.4% share—still with just

three models. "It's almost criminal what the previous management didn't do," says John Wolkonowicz, an analyst at researcher Global Insight Inc. "How could you freshen Sebrings and Neons and all but ignore Jeep?"

"OUR FAIR SHARE"

NOW JEEP IS READY to start filling in the blanks in its lineup. This fall, Chrysler will roll out the Commander, the brand's first contender with three rows of seating, an increasingly popular feature. A fully loaded Commander with a V-8 Hemi engine could go for \$43,000 or so, analysts speculate. Though that segment is crowded, Jeffrey A. Bell, vice-president of marketing and product planning for Jeep and Chrysler, says: "We're confident that the Jeep is a brand with so much equity that when we enter a segment, we will get our fair share or more." Maybe so, but rising gas prices have dented sales of some larger SUV rivals, such as the Chevy Suburban and Ford Expedition, forcing auto makers to slather on the incentives.

Jeep will also need to tread carefully at the opposite end of the SUV spectrum. It hopes to capture new customers in a couple of years with sport-utes that are smaller and nimbler. It may even go so far as to make these models look like boxy station wagons—harking back to the squared-off Grand Wagoneers of earlier decades. The

trick will be to keep these "soft-roaders" from undermining the macho image of Jeep's off-roaders. Chrysler says the answer is smooth-riding Jeeps that can still tackle tougher conditions than their rivals—a compelling marketing ploy even for folks who never veer from the pavement. Says Zetsche: "The speculation that we are going soft or doing stupid things to Jeep is untrue."

And it's not as though Jeep is suddenly going to become the American equivalent of mild-mannered Subaru. Case in point: the hulking

Gladiator concept, which looks as though it could flatten a cute-ute. Even rivals offer grudging praise. Says Robert A. Lutz, GM vice-chairman and a former Chrysler president: "It's clearly the direction Jeep needs to go." The only question is whether it is going there too late. ■

—By Kathleen Kerwin, with David Kiley and David Welch, in Detroit



The battlefield-ready **Gladiator** concept truck takes a shot at Hummer's macho crown, even as Jeep brings out more family fare.

COMMENTARY

BY WENDY ZELLNER

Waiting for the First Bird to Die

Delta's price war is bound to sink an airline or three. Who will fall soonest?

IT LOOKS AS IF the major airlines have nowhere left to hide. After four years of industry losses in the face of an economic slowdown, punishingly low fares, and high fuel prices, a shakeout now appears all but inevitable. The final blow may have come in early January with Delta Air Lines Inc.'s pricing revolution. The simplified structure is expected to batter already bleak revenues for

soon force the airline's demise. Foundering upstart Independence Air Inc. and low-cost ATA Airlines Inc., which is struggling to emerge from Chapter 11 after cutting a deal to sell some of its Chicago gates to Southwest, could also vanish. All told, those three carriers account for nearly 10% of domestic capacity.

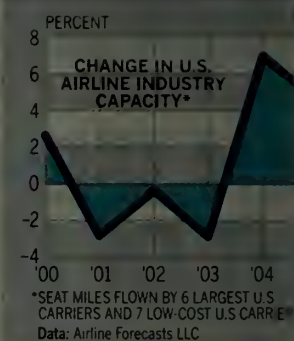
Bankrupt United Airlines, still wrangling for benefit concessions from its workers, isn't out of danger. If it succeeds in terminating its pension plans, "people will be so demoralized that the carrier couldn't survive," says Phil Roach Jr., general vice-president of the International Association of Machinists, which represents United's airport workers. That may be a bit of hyperbole. But even if these airlines manage to hang on, a shakeout is still imminent, driven in part by Delta's squeeze on revenues. Says J. Scott Kirby, executive vice-president of marketing at low-cost carrier America West Airlines Inc.: "I don't know if we get there through consolidation, liquidation, or a lot of airlines reducing capacity." But ultimately, he believes, "capacity rationalization" has to come. With its own losses mounting, America West has cut its growth plan nearly in half, to 3% to 5% this year.

However it occurs, an industry restructuring is well overdue. Despite wringing out enormous costs, carriers are expected to lose at least \$2 billion this year on top of last year's \$5.4 billion. Part of the mess can be chalked up to aggressive growth: After three years of shrinking, capacity rose 7% in 2004, says Val Cordero, CEO and chief analyst of AirlineForecasts LLC in Washington, D.C. Before Delta's bombshell, he forecast a 4.5% expansion this year. While much of the growth has come from low-cost counters, the big players have expanded, too, rather than ceding share to low-cost rivals. "What's perfectly logical at the individual airline level is completely irrational at the industry level," says Cordero.

That's why the failure of one or even two of the majors would be enough to save the ailing airlines. Any reduction in capacity is likely to be quickly filled by low-cost and legacy carriers. Southwest, for instance, would rapidly expand in Philadelphia should US Airways disappear. And that will keep the pressure on fares. "The notion of a competitor disappearing and solving the industry's problems is naive," says former American Airlines CEO Don Carty. No wonder the race is on to be a low-cost survivor.

—With Brian Grow in Atlanta and bureau reporters

TOO MANY SEATS?



everyone. Says Gary C. Kelly, chief executive of low-fare king Southwest Airlines Co.: "Something's got to give."

If it wasn't already clear enough, Delta's bold move underlines the new reality: The days of high-cost, high-fare airlines are over. By lowering and capping top fares, Delta is simply bowing to the inevitable and forcing its managers and employees to face the facts. After identifying \$5 billion in cost cuts, it will now have to work harder still to create an airline that can be profitable charging such fares. Delta's move also puts huge pressure on the other major carriers to speed their own restructurings. As they scramble to match Delta fare reductions, the industry as a whole could sacrifice \$2 billion in revenues. "The majors are realizing that if they don't accelerate their transformation, they will die," says James E. Owers, a finance professor and airline expert at Georgia State University.

Nowhere is that clearer than at US Airways. Despite major cost-cutting strides in its second round of bankruptcy, workers angered by repeated concessions and wary creditors and investors could



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GOVERNMENT

OUT OF INDIANA, INTO THE FRYING PAN

Can an old Harvard buddy keep Bush's economic policy on track?

WHEN PRESIDENT George W. Bush announced the appointment of Indiana businessman Allan B. Hubbard as head of the National Economic Council on Jan. 10, you could almost hear the Beltway cognoscenti snicker. At first glance, Hubbard seems like the latest appointee whose

crony would be a serious misreading of the influence he could wield. "The notion that he is some kind of naïf is off base," says William Kristol, editor of *The Weekly Standard* and Hubbard's boss when both were aides to former Veep Dan Quayle. "He is going to make a big splash."

Bush has to hope this prediction pans out, because his Texas-size second-term agenda presents a huge challenge.

BIO

Allan B. Hubbard

BORN Sept. 8, 1947, in Jackson, Tenn.

NEW JOB As head of the White House National Economic Council, Hubbard must help President Bush push through his ambitious second-term agenda, which includes overhauling Social Security, simplifying the tax code, and limiting frivolous lawsuits.

OLD JOB President of Indianapolis-based E&A Industries, a closely held investment firm he founded in 1977. Today, E&A owns three specialty chemical companies and a lighting company.

EDUCATION BA from Vanderbilt University in 1969; MBA in 1975 from Harvard Business School, where he first met George W. Bush.

GOVERNMENT SERVICE During Bush I, ran the President's Council on Competitiveness. There he tried to impose tougher hurdles for new regulatory proposals.

KEY ASSETS Hubbard is a conciliator, adept at bringing people together. His rep as a Presidential confidant will magnify his power.

chief qualification appears to be unswerving loyalty. A classmate of George W.'s at Harvard Business School, Hubbard is one of Bush's oldest chums and a top fundraiser. Unlike departing NEC honcho Stephen Friedman, former chairman of Goldman, Sachs & Co., he is not a well-known financier. Hubbard, 57, made his fortune by acquiring a band of small manufacturing outfits under the rubric of Indianapolis-based E&A Industries Inc.

But dismissing Hubbard as a mere

He faces bruising battles over Social Security private accounts and, next year, over tax reform. Fights with Democrats also loom over plans to limit jury awards, revive a first-term energy bill, and put tight clamps on domestic spending.

So why Hubbard? GOP sources say he's an unflappable manager with a knack for conciliation. He mastered the first as Quayle's deputy chief of staff, fending off liberal critics and White House aides who wanted the Veep dumped.

Possessed of an entrepreneur's for red tape, he wound up heading White House Council on Competitiveness, a Quayle project. There "everything possible to slow new regulations," says an associate. His negotiating skills came in later, as a member of Bush II's brain trust during the campaign. Bush's top economic adviser, Lawrence B. Lindsey, and an influential economist, former Council of Economic Advisers Chairman Michael J. Boskin, were engaged in protracted debates about the shape of Bush's first tax cut. Hubbard kept the process moving. After the tax cut passed Congress, he remained an ex-officio member of the council, serving as a key conduit to the President.

SYNC THE SHIP

IN HIS ROLE as coordinator, Hubbard won't be expected to make policy as much as to ensure that the President's advisers are all rowing in the same direction. Already, there are signs that more synchronization is needed. As the Bush team has begun to push for Social Security reform, mixed signals and a lack of specifics have troubled allies.

Once he settles into the job, Hubbard is expected to be a powerful backstage presence—like former NEC chief Robert Rubin in the early Clinton administration. Hubbard's closeness to the President "gives him instant street cred," says Indiana Governor Mitch Daniels Jr., a Hubbard pal. He was Bush's first budget chief.

Like Rubin, Hubbard is a deficit hawk. He has privatized over one of the less successful legacies of Bush's first term: the ocean of red ink. That makes him a natural ally of Budget Director Josh Bolten, who worked with Hubbard on the 2000 campaign.

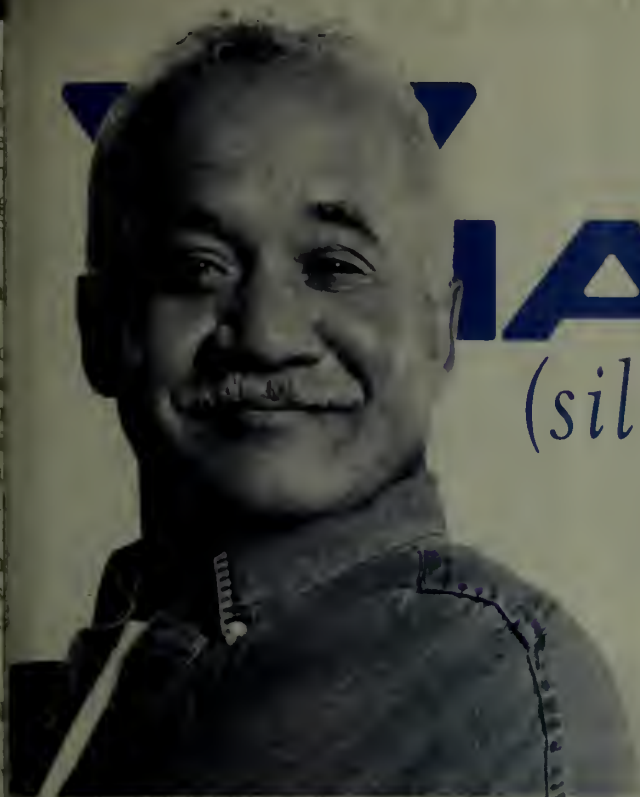
For the moment, Hubbard is holding his cards close to his vest. He is expected to devote his first weeks in Washington to getting a grip on Team Bush's economic policy machinery. He will also have to tend to divesting many of his financial holdings. Once those issues are sorted out, Hubbard can turn to the task at hand—pushing a second-term agenda that, to skeptics at least, seems to far strip the reelected President's political chits. In this, he can take some comfort from one fact: Both he and his boss have their labors underestimated by foes.

—By Lee Walczak and Rich Miller, Richard S. Dunham in Washington



DEFICIT HAWK
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The most common side effects of VIAGRA are headache, facial flushing, and upset stomach. Less common are bluish or blurred vision, or being sensitive to light. These may occur for a brief time. Remember to protect yourself and your partner from sexually transmitted diseases.

Talk with your doctor first. Make sure you are healthy enough to have sex. If you have chest pain, nausea, or other discomforts during sex, seek medical help right away. The same is true if you have an erection that lasts more than 4 hours. Call for help at once.

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PATIENT SUMMARY OF
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This summary contains important information about VIAGRA®. It is not meant to take the place of your doctor's instructions. Read this information carefully before you start taking VIAGRA. Ask your doctor or pharmacist if you do not understand any of this information or if you want to know more about VIAGRA.

This medicine can help many men when it is used as prescribed by their doctors. However, VIAGRA is not for everyone. It is intended for use only by men who have a condition called erectile dysfunction. **VIAGRA must never be used by men who are taking medicines that contain nitrates of any kind, at any time. This includes nitroglycerin. If you take VIAGRA with any nitrate medicine your blood pressure could suddenly drop to an unsafe or life threatening level.**

• **What is VIAGRA?**

VIAGRA is a pill used to treat erectile dysfunction (impotence) in men. It can help many men who have erectile dysfunction get and keep an erection when they become sexually excited (stimulated).

You will not get an erection just by taking this medicine. VIAGRA helps a man with erectile dysfunction get an erection only when he is sexually excited.

• **How Sex Affects the Body**

When a man is sexually excited, the penis rapidly fills with more blood than usual. The penis then expands and hardens. This is called an erection. After the man is done having sex, this extra blood flows out of the penis back into the body. The erection goes away. If an erection lasts for a long time (more than 6 hours), it can permanently damage your penis. You should call a doctor immediately if you ever have a prolonged erection that lasts more than 4 hours.

Some conditions and medicines interfere with this natural erection process. The penis cannot fill with enough blood. The man cannot have an erection. This is called erectile dysfunction if it becomes a frequent problem.

During sex, your heart works harder. Therefore sexual activity may not be advisable for people who have heart problems. Before you start any treatment for erectile dysfunction, ask your doctor if your heart is healthy enough to handle the extra strain of having sex. If you have chest pains, dizziness or nausea during sex, stop having sex and immediately tell your doctor you have had this problem.

• **How VIAGRA Works**

VIAGRA enables many men with erectile dysfunction to respond to sexual stimulation. When a man is sexually excited, VIAGRA helps the penis fill with enough blood to cause an erection. After sex is over, the erection goes away.

• **VIAGRA Is Not for Everyone**

As noted above (*How Sex Affects the Body*), ask your doctor if your heart is healthy enough for sexual activity.

If you take any medicines that contain nitrates — either regularly or as needed — you should never take VIAGRA. If you take VIAGRA with any nitrate medicine or recreational drug containing nitrates, your blood pressure could suddenly drop to an unsafe level. You could get dizzy, faint, or even have a heart attack or stroke. Nitrates are found in many prescription medicines that are used to treat angina (chest pain due to heart disease) such as:

- nitroglycerin (sprays, ointments, skin patches or pastes, and tablets that are swallowed or dissolved in the mouth)
- isosorbide mononitrate and isosorbide dinitrate (tablets that are swallowed, chewed, or dissolved in the mouth)

Nitrates are also found in recreational drugs such as amyl nitrate or nitrite ("poppers"). If you are not sure if any of your medicines contain nitrates, or if you do not understand what nitrates are, ask your doctor or pharmacist.

VIAGRA is only for patients with erectile dysfunction. VIAGRA is not for newborns, children, or women. Do not let anyone else take your VIAGRA. VIAGRA must be used only under a doctor's supervision.

• **What VIAGRA Does Not Do**

- VIAGRA does not cure erectile dysfunction. It is a treatment for erectile dysfunction.
- VIAGRA does not protect you or your partner from getting sexually transmitted diseases, including HIV — the virus that causes AIDS.
- VIAGRA is not a hormone or an aphrodisiac.

• **What To Tell Your Doctor Before You Begin VIAGRA**

Only your doctor can decide if VIAGRA is right for you. VIAGRA can cause mild, temporary lowering of your blood pressure. You will need to have a thorough medical exam to diagnose your erectile dysfunction and to find out if you can safely take VIAGRA alone or with your other medicines. Your doctor should determine if your heart is healthy enough to handle the extra strain of having sex.

Be sure to tell your doctor if you:

- have ever had any heart problems (e.g., angina, chest pain, heart failure, irregular heart beats, heart attack or narrowing of the aortic valve)
- have ever had a stroke
- have low or high blood pressure
- have a rare inherited eye disease called retinitis pigmentosa
- have ever had any kidney problems
- have ever had any liver problems
- have ever had any blood problems, including sickle cell anemia or leukemia
- are allergic to Sildenafil or any of the other ingredients of VIAGRA tablets
- have a deformed penis, Peyronie's disease, or ever had an erection that lasted more than 4 hours
- have stomach ulcers or any types of bleeding problems
- are taking any other medicines

• **VIAGRA and Other Medicines**

Some medicines can change the way VIAGRA works. Tell your doctor about **any medicines** you are taking. Do not start or stop taking any medicines before checking with your doctor or pharmacist. This includes prescription and nonprescription medicines or remedies:

- Remember, VIAGRA should never be used with medicines that contain nitrates (see *VIAGRA Is Not for Everyone*).
- If you are taking alpha-blocker therapy for the treatment of high blood pressure or prostate problems, you should not take a dose of greater than 25 mg of VIAGRA at the same time (within 4 hours) as you take your dose of alpha-blocker.
- If you are taking a protease inhibitor, your dose may be adjusted (please see *Finding the Right Dose for You*).
- VIAGRA should not be used with any other medical treatments that cause erections. These treatments include pills, medicines that are injected or inserted into the penis, implants or vacuum pumps.

• **Finding the Right Dose for You**

VIAGRA comes in different doses (25 mg, 50 mg and 100 mg). If you do not get the results you expect, talk with your doctor. You and your doctor can determine the dose that works best for you.

- Do not take more VIAGRA than your doctor prescribes.
- If you think you need a larger dose of VIAGRA, check with your doctor.
- VIAGRA should not be taken more than once a day.

If you are older than age 65, or have serious liver or kidney problems, your doctor may start you at the lowest dose (25 mg) of VIAGRA. If you are taking protease inhibitors, such as for the treatment of HIV, your doctor may recommend a 25 mg dose and may limit you to a maximum single dose of 25 mg of VIAGRA in a 48 hour period. If you are taking alpha-blocker therapy, you should not take a dose of greater than 25 mg of VIAGRA at the same time (within 4 hours) as your dose of alpha-blocker.

• **How To Take VIAGRA**

Take VIAGRA about one hour before you plan to have sex. Beginning in about 30 minutes and for up to 4 hours, VIAGRA can help you get an erection if you are sexually excited. If you take VIAGRA after a high-fat meal (such as a cheeseburger and french fries), the medicine may take a little longer to start working. VIAGRA can help you get an erection when you are sexually excited. You will not get an erection just by taking the pill.

• **Possible Side Effects**

Like all medicines, VIAGRA can cause some side effects. These effects are usually mild to moderate and usually don't last longer than a few hours. Some of these side effects are more likely to occur with higher doses. The most common side effects of VIAGRA are headache, flushing of the face, and upset stomach. Less common side effects that may occur are temporary changes in color vision (such as trouble telling the difference between blue and green objects or having a blue color tinge to them), eyes being more sensitive to light, or blurred vision.

In rare instances, men have reported an erection that lasts many hours. You should call a doctor immediately if you ever have an erection that lasts more than 4 hours. If not treated right away, permanent damage to your penis could occur (see *How Sex Affects the Body*).

Heart attack, stroke, irregular heart beats, and death have been reported rarely in men taking VIAGRA. Most, but not all, of these men had heart problems before taking this medicine. It is not possible to determine whether these events were directly related to VIAGRA.

VIAGRA may cause other side effects besides those listed on this sheet. If you want more information or develop any side effects or symptoms you are concerned about, call your doctor.

• **Accidental Overdose**

In case of accidental overdose, call your doctor right away.

• **Storing VIAGRA**

Keep VIAGRA out of the reach of children. Keep VIAGRA in its original container. Store at 25°C (77°F); excursions permitted to 15-30°C (59-86°F) [see USP Controlled Room Temperature].

• **For More Information on VIAGRA**

VIAGRA is a prescription medicine used to treat erectile dysfunction. Only your doctor can decide if it is right for you. This sheet is only a summary. If you have any questions or want more information about VIAGRA, talk with your doctor or pharmacist, visit www.viagra.com, or call 1-888-4VIAGRA.



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September 2002



THE COURTS

CORPORATE CASES: TIME TO CUT A DEAL?

new ruling could empower defendants until Congress rewrites sentencing rules

AT A TIME WHEN SOME of the highest-profile white-collar cases in history are about to go to trial, the U.S. Supreme Court has just upended the playing

In a pair of consolidated cases announced on Jan. 12, *U.S. v. Booker* and *v. Fanfan*, it held that the Federal Sentencing Guidelines unconstitutional—a move that gives judges much more discretion in sentencing criminals. So what does this mean for Enron Corp. Chairman Kenneth Lay and CEO Jeffrey K. Skilling, former WorldCom Inc. CEO Bernard J. Ebbers, and the other onetime celebrity executives scheduled to face juries?

In the short term, they're likely to enjoy greater leverage in battles against federal prosecutors. (Both Lay and Ebbers say they did nothing wrong). But longer-term, other execs could suffer if Congress revises the Sentencing Guidelines to punish unpopular business criminals more harshly than the old system did. The federal sentencing rules, which

went into effect in 1987, were intended to ensure that similar crimes received similar punishments. But in the *Booker* and *Fanfan* cases—which had been widely anticipated because of a similar decision last year concerning state sentencing guidelines—the high court held the federal regime violated the Sixth Amendment guarantee of the right to trial by jury.

“The Justice Dept. has been using the guidelines to induce pleas...that leverage is markedly diminished”

—Frank Bowman
former federal prosecutor and Professor of Law, Indiana University School of Law

That's because the guidelines often require judges to make factual determinations about issues that aren't presented to jurors, such as whether the defendant displayed remorse or played a leadership role in a particular criminal conspiracy. Writing for one of the two majority opinions, Justice Stephen G. Breyer called on Congress to fix the legal problems identified by the

BETTER OFF? From Supreme Court. left, Enron's Skilling and Lay; WorldCom's Ebbers
“The ball now lies in Congress's court,” he wrote.

His words warmed the hearts of many criminal defense lawyers—and their clients. Under the old guidelines, punishments were largely set in stone. If a prosecutor pushed for a stiff jail sentence, accused criminals had little hope of leniency from judges.

LESS LEVERAGE?

BECAUSE SENTENCING guidelines are now just advisory, however, jurists will have far greater power to set jail time. That means criminal defendants may feel empowered to take tougher negotiating stances in plea-bargain talks. “The Justice Dept. has been using the guidelines to induce pleas. If the guidelines are advisory, that leverage is markedly diminished,” says Frank O. Bowman, a former federal prosecutor who now teaches at the Indiana University School of Law.

White-collar criminals who are unable to reach pre-trial plea deals and are subsequently convicted by juries are also likely to benefit. That's because the sentencing guidelines list a series of factors that can either increase or decrease a prison term. For businesspeople, the most important ones are the amount of money involved in the fraud, the extent of their supervisory and fiduciary responsibilities, and the vulnerability of the victims. The main mitigating factor is whether they cooperated with investigators.

In most white-collar cases, aggravating factors tend to outweigh mitigating factors, leading to harsher penalties under the old rules. “Because business cases involve so much money—much more than, say, a drugstore robbery—the sentencing guidelines have not been a happy development for corporate defendants,” says Joel Seligman, a corporate law specialist and dean of the School of Law at Washington University in St. Louis.

Still, the call to rewrite the guidelines is likely to be taken seriously by Congress. Lawmakers face pressure from prosecutors, victims' rights groups, and consumer watchdogs to restore a legal version of the old regime. “In the post-Enron world, things can only get worse for corporate defendants” in Congress, says Houston criminal defense lawyer Philip H. Hilder. So it may be premature for corporate defendants to pop the champagne. ■

—By Lorraine Woellert in Washington and Mike France in New York

COMMENTARY

BY WILLIAM C. SYMONDS

Leaving Harvard Greener

Investment superstar Jack Meyer's legacy is worth every penny he was paid

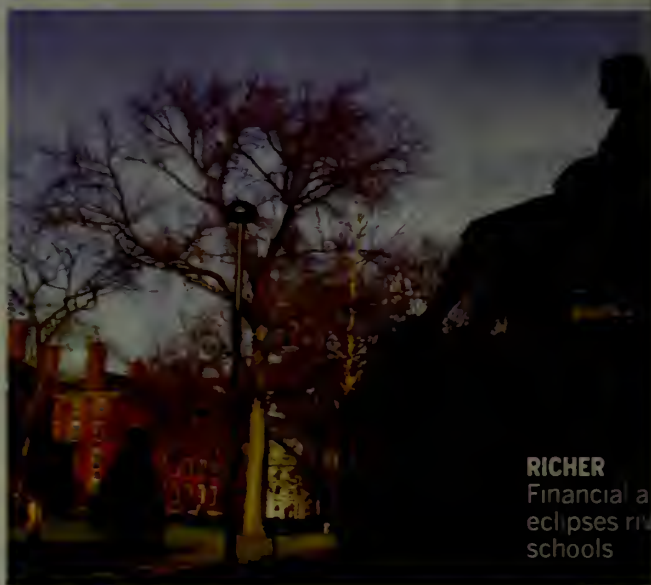
JACK R. MEYER, the investing superstar who heads the in-house firm that manages Harvard University's massive endowment, is stepping down after a phenomenal run—and his critics are rejoicing. Meyer announced on Jan. 11 that he plans to leave this summer to launch his own firm. Despite his strong performance, Meyer's departure is being hailed by those who complain that

Harvard has grossly overpaid both Meyer and his investment team. In fiscal 2004 alone, Meyer and his top five managers were paid \$78.4 million.

No doubt, that's a lot of dough. But the critics have got it wrong: Harvard was lucky to have Meyer. When he arrived in 1990, the university had a \$4.7 billion endowment. Now, it stands at \$22.6 billion. Over the past decade, Harvard Management Co. has achieved an annual return of 15.9%—more than 50% higher than the returns posted by the median large institutional fund. Meyer and his team did even better in the bond market over the past five years, posting returns more than twice the industry average. Such outperformance has generated an extra \$12.2 billion for Harvard over the last decade alone—an amount nearly equal to the entire endowment of Yale, the nation's second-wealthiest university.

Those investment returns have helped transform Harvard, enabling President Larry Summers to embark on an extraordinarily ambitious agenda. Consider the critical issue of financial aid. Just 3% of students at the nation's top 146 colleges come from families in the bottom socioeconomic quartile. "For the first time probably in the history of our country, the gap in life prospects between the children of the fortunate and the children of the less fortunate is rising," Summers warned in a recent interview with *BusinessWeek*.

Yet thanks to Meyer's success, Summers was able to announce in 2003 that any student with a family income of less than \$40,000 could attend Harvard "with no parental contribution at all." Harvard has also been boosting its financial aid budget at a double-digit clip, and the endowment now covers 72% of undergraduate financial aid. In contrast, the University of Chicago's



RICHER
Financial aid eclipses rival schools

endowment covers only about a quarter of that institution's financial aid budget. And Chicago is one of the nation's richest universities.

Meyer's investment windfall has also allowed Harvard to beef up its educational resources. Money has gone into hiring more professors and expanding Harvard's role in the sciences, including plans for a new engineering school. And Summers has begun a massive expansion that he predicts will reshape Harvard "for the next century or two." But without Meyer's financing such lofty ambitions will be tougher.

Harvard Management is now at a crossroads. The university could mollify critics by hiring outside managers to manage most of its assets, as most universities do. In fact, many of Meyer's well-paid stars have already left, taking with them some of Harvard's most valuable assets. But Meyer warns that if Harvard chooses this route, "our fees will go up and our returns will go down." Indeed, last fall Summers estimated that if he turned over all Harvard's assets to outsiders, "we'd be spending \$100 million a year more getting our endowment managed."

Sure, Meyer's pay is outrageous in academia, where even top professors often make less than \$150,000. But if anything, Meyer and his colleagues have been underpaid by Wall Street standards—which is one reason so many have fled. That's proof positive that Meyer has been a real bargain for Harvard. ■

THE STAT

\$17.9
Billion

Increase in Harvard's endowment under Jack Meyer, thanks mostly to returns 50% higher than rival funds'

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Equity Income Fund	15.05%	7.67%	13.00%
Lipper Equity Income Funds Average	12.81%	4.17%	11.13%
Growth Stock Fund	10.24%	0.15%	12.21%
Lipper Large-Cap Growth Funds Average	7.18%	-8.22%	8.55%

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EDITED BY ANNE NEWMAN

HEADLINER

MICHAEL CHERTOFF



HOMELAND HONCHO

Can a corporate crimefighter tame the **Homeland Security Dept.**? President Bush hopes so. On Jan. 11, he tapped U.S. Circuit Appeals Court Judge Michael Chertoff, onetime head of the Justice Dept.'s Criminal Div., as Homeland Security Secretary.

It's not Chertoff's first time fighting terror: At Justice, he made crucial decisions on detaining illegal immigrants suspected of involvement with September 11. That and his work on the Patriot Act drew a caution from the ACLU, while Democrats remember his role as chief counsel on the Whitewater probe. Still, Chertoff, 51, is likely to win easy Senate confirmation: Even Senator Hillary Clinton (D-N.Y.) vowed to give him "careful consideration." The tough part will come later, when Chertoff—who hasn't run anything bigger than the Criminal Div.—tries to unspool two-year-old Homeland Security, where 180,000 workers in 22 agencies lack a common computer system and answer to dozens of Capitol Hill barons.

—Paul Magnusson

PENSION REFORM: NEXT?

Social Security isn't the only retirement system in disrepair, the Bush Administration acknowledged this week. On Jan. 12, Labor Secretary Elaine Chao put forth a plan to shore up the **Pension Benefit Guaranty Corp.**, the government-supported insurer of private pension plans. With these plans now underfunded by an estimated \$450 billion, and with two of the largest and most troubled air carriers terminating their pension plans, the emphasis is on getting more money into the PBGC both by upping insurance premiums from \$19 a head to \$30 and by requiring more funding by struggling employers. Yet the PBGC already has a \$23 billion deficit. Now it's up to Congress, which has typically vacillated on pension reform, to hammer out a plan.

TURNOVER AT MOTOROLA



When **Motorola** tapped Ed Zander (above) of **Sun Microsystems** in 2003 to replace Christopher Galvin as CEO, operations chief Mike Zafirovski was expected to leave after being passed over for the top job. Only now has he decided to resign, announcing on Jan. 12 that he will move on at the end of the

month. Zafirovski, 51, stayed to perk up execution, boost profitability, and help Zander spin off the semiconductor unit and merge five other divisions into four. With Motorola set to report its fourth consecutive quarter of solid earnings on Jan. 18, Zafirovski is hunting for a CEO opportunity. Motorola has no plans to name another operations chief.

GIVING BACK THE BONUS

A dozen executives at **Nortel Networks** will give back \$8.6 million in bonuses based on faulty accounting. The givebacks, announced on Jan. 11 after Nortel restated results for 2001 to 2003, are part of a massive cleanup at the phone-equipment maker. As a result of an internal probe of bookkeeping, five directors are leaving and two new ones are being named. Such givebacks are rare, but that may change. The Sarbanes-Oxley Act requires execs to fork over bonuses or stock profits that result from accounting restatements. Already, Fannie Mae has come under fire for deferring expenses in 1998, making top execs eligible for nearly \$6 million in bonuses. And HealthSouth is going after payments received by former Chairman Richard Scrushy. The message for CEOs? Don't cash that bonus check too soon.

MICROSOFT'S CFO WILL SPLIT

The man who engineered the largest dividend payout in history will soon be history himself at **Microsoft**. Chief Financial Officer John Connors said on Jan. 11 he will leave by spring to work as a venture capitalist with

Ignition Partners of Bellevue, Wash. Connors, a favorite of Microsoft CEO Steven Ballmer, will best be remembered for overseeing a \$32 billion special dividend payout in December. But Connors also watched Microsoft shares slide 7% during his five-year CFO tenure, compared with a decline in the NASDAQ.

ET CETERA...

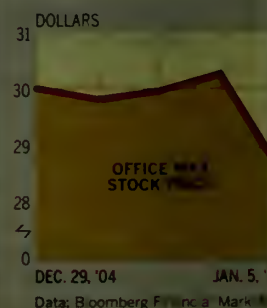
➤➤ **GM** will sell its locomotive manufacturing unit to two investment firms.

➤➤ **SBC** and **Hewlett-Packard** will jointly develop and sell market products and services.

➤➤ Economist and *World Philosophers* author **Robert Heilbroner**, 85, died on Jan. 10.

CLOSING BELLS

OfficeMax shares fell 4.7% on Jan. 11 after the company said its new CFO had resigned and wouldn't release earnings until it got results of a previously reported internal accounting probe. The Itasca (Ill.) company said it has found problems with vendor payments





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GERMANY

SIEMENS' NEW BOSS: CAN HE DELIVER?

The ferociously energetic Klaus Kleinfeld is aiming for one thing the giant doesn't make: World-class profits

WORKERS AT A Siemens unit that makes X-ray machines and other diagnostic equipment were shocked when, in 1998, a cocky new boss asked them to work more flexible shifts to speed production. The new guy, a 40-year-old up-and-comer named Klaus Kleinfeld, even wanted weekend shifts, then practically unheard of. Yet employee representatives knew the unit in Forchheim, Bavaria, was getting beat up by General Electric Co., and that shareholders wanted Siemens to dump its medical equipment unit. Everyone's job was on the line.

The negotiations were tough. But Kleinfeld won over workers, hanging around the factory asking detailed questions. He an-

swered e-mails from employee reps almost immediately, even late at night, recalls Werner Mönius, chairman of the worker's council in Erlangen, Germany, home base of Siemens Medical Solutions. "He was able to motivate people to pull together," says Mönius. The workers signed off on Kleinfeld's plan, which helped cut the time it took to build a \$100,000-plus diagnostic scanner from six weeks to one. Siemens Medical Solutions Div. is now Siemens' most profitable business.

And that cocky young boss? This month Kleinfeld, now 47, becomes chief executive of Munich-based Siemens, a \$100 billion behemoth that operates in 190 countries and makes subways, light bulbs, power plants, auto parts, automatic mail-sorting gear, and more. With 430,000 employees and 12 major divisions, Siemens is the rock of Germany

Inc., which still needs to learn how to live and thrive in a world where he taxed, slow-moving European companies operate at a disadvantage. If Siemens reach new levels of profitability, the rest of Corporate Germany has a chance, too.

OPERA MAN

SIEMENS CHIEF Executive Heinrich Pierer and the company's supervisory board skipped over more seasoned managers to choose the ferociously energetic Kleinfeld. He represents a breed of German manager, fluent in English and comfortable in settings from Tokyo to Toledo. With his big laugh and knack for storytelling, Kleinfeld knows how to network globally as well. He sits on several corporate and charitable boards abroad, including those of minimum-products maker Alcoa and Metropolitan Opera in New York. "I know him. He's a generous, funny man," says Beverly Sills, chairman of the Met, who gushes about Kleinfeld's ability to praise opera performances.

Kleinfeld should not let such praise go to his head. His swift rise and role as an internal consultant at Siemens, who had him parachuting in to fix troubled businesses, inevitably bred resentment in some quarters. And it will take Kleinfeld years to match the stature of von Pierer, now something of a national hero steering Siemens through an age of rapid globalization. If Kleinfeld pushes change too hard, he will face resistance from all quarters.

If nothing else, Kleinfeld should put to rest stereotypes about dour German execs. At a November dinner in Munich with business journalists, one It-

BIO

Klaus Kleinfeld

BORN Nov. 6, 1957, in Bremen, Germany.

EARLY HARD KNOCK Loses father at age 10, works odd jobs to help support mother.

EVIDENCE OF DRIVE Completes doctoral work in strategic management at University of Würzburg while employed full time at Siemens and raising young family.

MAJOR ACHIEVEMENTS Built Siemens' internal consulting unit almost from scratch; helped lead

turnaround of Medical Solutions business; led rebound of Siemens' operations in the U.S.

MOST UNUSUAL CAREER EXPERIENCE As young man did consulting for a dog-food producer.

WHAT HE DOES IN HIS FREE TIME Runs marathons (finished the 2004 New York Marathon in 5 hours, 18 minutes).

FAMILY LIFE Married to high school sweetheart, two children.





Ullrich 38% of
men's workforce
Germany

He waved his Nokia mobile phone in Kleinfeld's face and demanded to know if Siemens can compete with the handset industry's market leader. Kleinfeld replied by snatching the Nokia phone and dropping it in a glass of water. Message: We'll drown the competition. (Kleinfeld later gave the journalist a waterproof Siemens phone instead.) But the reporter's question was legitimate. Does Kleinfeld have what it takes to fix Siemens' money-losing mobile-handset business and other underperformers? On the plus side, he inherits a company that has come far since von Pierer took over in 1992. Since then sales have nearly doubled, to \$98 billion, and profit has more than tripled, to \$4.5 billion, a sum analysts expect to increase by at least 10% in 2005. But Siemens still suffers in comparison

with archrival GE, whose shares have had a total return of 423% over the last 10 years, vs. 273% for the German company. It's not just a question of cutting costs. "In the innovation game, productivity and R&D matter more than cost structure," says William M. Castell, CEO of GE Healthcare. Siemens boasts that it gener-

ates more than 8,000 inventions a year, but it needs to do more to turn them into profitable products. Siemens must also persuade the market to value it for more than its 12 units would be worth separately. Munich bank HVB Group figures Siemens is worth about \$96 per share based on a sum-of-the-parts valuation. The stock trades around \$80. "You never [see] a great year when all businesses are performing well," says Henning Gebhardt, head of German equities at DWS, a mutual-fund company.

INSIDE PEEKS

CAN HE SUCCEED? Kleinfeld doubtless has the drive. His father died when the boy was 10—a "brutal" experience, Kleinfeld says. An only child, he stocked grocery shelves at age 12. After studying business at Georg August University in Göttingen, Kleinfeld put in stints at a Nuremberg market research firm and at drugmaker Ciba-Geigy before joining Siemens in 1987. He completed his doctorate at the University of Würzburg while working full time at Siemens and raising a family. "That

was an extreme burden," recalls Ulli Arnold, now a business professor at University of Stuttgart, who supervised Kleinfeld's thesis work on corporate identity and strategic management. Kleinfeld's stamina has, if anything, increased. George C. Nolen, CEO of Siemens Corp., the company's U.S. unit, recalls returning from a European trip with Kleinfeld. "I was dead tired, and he runs the New York City marathon," Nolen says.

Kleinfeld has held 10 jobs within Siemens in 17 years, including building up the in-house consulting arm. Under Kleinfeld, it grew from 8 consultants to 170 operating under direct control of the management board, and it was involved in turnarounds of divisions such as power generation. His job-hopping and role as

Siemens vs. GE

Where the German giant lags

	SIEMENS	GE
Total Return 1995-2004	273.0 %	423.0%
Operating Margin*	4.0	14.2
Return on Equity**	13.5	18.1

*Qtr. ended 9/30/04 **12 mos. ended 9/30/04 Data: Bloomberg Financial Markets

an internal consultant have led to muttering that Kleinfeld is short on operational experience. But his stint as a consultant has also allowed him to explore every corner of the Siemens empire. He enjoys telling tales of his adventures, such as an all-night session with the glum managers of a troubled Japanese unit. Fatigue and sake loosened their reserve until they worked out a new business plan.

TEAM TURNAROUND

KLEINFELD WAS ONE of the main inventors of One Siemens, a program designed to promote internal cooperation. He got a chance to put theory into practice when Siemens sent him to the U.S. in January, 2001, first as chief operating officer, and, a year later, as CEO of New York-

based Siemens Corp. Under Kleinfeld, units including Medical Solutions and Power Transmission & Distribution teamed up to supply diagnostic gear, software, telecommunications, and power to a hospital being built in Temple,

Will the money-losing handset unit be sold?

Tex., for Scott & White Healthcare System. It worked: Kleinfeld inherited a roughly \$500 million loss when he arrived in the U.S. When he left, U.S. operations were \$500 million in the black.

Last year his fingerprints were on the choice to merge Siemens' mobile and land-line telecom businesses. But more job cuts may be necessary, and the money-losing handset business may have to merge with a rival. Kleinfeld probably can't take such action without the support of von Pierer, who will stay on as chairman of the supervisory board. But he may get it. Von Pierer has said sale or closure of the handset unit are options.

A whole generation of young Siemens executives, meanwhile, is rooting for Kleinfeld. Robert H. Schaffer, a Stamford (Conn.) consultant who has helped design training programs for Siemens as well as GE, says mid-level managers at Siemens "are as bright and as aggressive as any I have met." The talent is there. But the task—transforming the prime symbol of Germany Inc.—is huge. ■

—By Jack Ewing in Frankfurt, with Diane Brady in New York

TOP TIER OR BUST CEO
Kim has boosted R&D spending and employee targets



ELECTRONICS

KOREA'S LG MAY BE THE NEXT SAMSUNG

By studying its rival's success, the digital player is close to becoming a global brand

IT WAS HARD TO MISS the ambitions of LG Electronics Inc. at the giant Consumer Electronics Show in Las Vegas in early January. LG's happy-face logo and phones were plastered on banners running a quarter mile in any direction from the convention center just off the Strip. Inside the hall, 42-inch LG plasma TVs displayed maps of the exhibit area. At its 19,000-square-foot booth, the company showed off new products ranging from a \$180 MP3 player the size of a matchbook to a 71-inch plasma TV (\$77,000) meant to outshine offerings by Sony, Samsung, or Panasonic. "You shouldn't be second-tier forever," says LG Chief Executive Kim Ssang Su. "We've got to be a top-notch player."

Sound familiar? It should. That's kind of talk the industry has been hearing for years from LG's crosstown rival Samsung Electronics Co. Under Park Jeong-hee, who took over in October, 2003, LG aimed to be a digital trendsetter—and by 2005, one of the world's top three home electronics players. "We must be a great company with great people," he declared.

It's like Korea in the old days, when the *chaebol* laid siege to one global industry after another. Except many of those forays were exercises in profit expansion, while LG is making money. Sales grew 21%, to \$23.6 billion, in 2004, with net profits expected to more than double, to \$1.5 billion. The company is the world's top maker of household conditioners and the No. 3 appliance

They've got the new suits.

We've got the old pros.

firms hire right off the college campus, dress their new
in nice suits, and put them on your critical assignment.
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maker. It's also No.3 globally in plasma TVs, while its joint venture LG.Philips LCD Co. is the largest maker of liquid-crystal displays for TVs. LG boosted handset sales from 6.9 million in 2000 to 44 million last year, and it is the top supplier to Verizon Wireless. In September, LG claimed 7% of the global handset market, according to researcher Strategy Analytics, making it No.5 globally. It's aiming for No.3 within two years.

Despite all the success, LG remains obsessed with Samsung. Until the mid-1990s the two companies were neck-and-neck in the race to become Korea's top electronics producer. But as Samsung went on a global brand-building push, LG made an ill-timed bet on telecommunications just as the business hit the skids. That touched off an investor panic in 2000, when LG's shares plunged by 75%.

CREDIBILITY GAINS

TODAY THAT TELECOM strategy is history—and LG execs admit they have a lot to learn from Samsung. CEO Kim speaks highly of the way Samsung pushed its employees "to the brink of the cliff" by creating a sense of crisis. Park Mun Hwa, who heads LG's handset business, says he uses Samsung's strategy as a template. "Samsung is our teacher," he says.

The pupil is a quick study. Although LG isn't anywhere as well-known as Samsung, it's being taken far more seriously than it used to be. "LG has done a credible job in establishing itself on the global market," says Chang Il Hyung, senior vice-president at Samsung Electronics. "I think it is more than plausible" that LG can make its way into the top ranks of global brands, says Daniel Kim, a Merrill Lynch & Co. analyst. Mike Cost, who deals with suppliers for Cingular Wireless, lauds LG's "attractive portfolio of

handsets." Cingular and its merger partner, AT&T Wireless, bought a combined six million phones from LG last year.

The respect LG is getting these days is largely due to CEO Kim. The son of a farmer, he started as an engineer in an LG refrigerator factory and worked his way up through the appliance division. Since his promotion to CEO, he has become a demanding taskmaster. "I hate to hear people say LG is a comfortable place to work," Kim says. "I want it to be a tough place." Kim moved executive staff meetings up an hour, to 7 a.m. from 8 a.m., and set sky-high targets for execs and lower-level employees alike. But he's also investing in the future. LG earmarked \$1.73 billion for R&D in 2005, or 6% of sales, largely for handsets, digital TVs, and flat panels. "You need good bullets and weapons on the battlefield," Kim says.

The vanguard of Kim's assault will be the handset division. Like Samsung, LG believes that once consumers have an LG phone in hand, they're more likely to turn to the brand when buying a TV, video recorder, or refrigerator. This year the company plans to spend \$200 million to market handsets in the U.S.—double its spending last year—largely in conjunction with carriers that are LG customers.

LG's technical prowess is sup-

plemented by a gro team of world-class designers. In the past year, LG increased its design team 40%, to 500. At the design center in Kangnam, a S neighborhood of gall nightclubs, and cafes, designers clad in jeans sneakers are in the fore of LG's pursuit of must-products for hip young sumers. "Increasingly, signers are seen as creat value," says Yang Jung M 28-year-old color artist.

Can LG repeat the suc of Samsung? Skeptics that the company's proje

2004 profit of \$1.5 billion pales be Samsung's \$10 billion—though ha Samsung's earnings come from its division. LG's margins for handset 7%, are less than half Samsung's—w LG attributes to smaller production umes and high spending on R&D. Erosion is so rapid in displays and that the LCD business, which earned of LG's profits last year, may contrib much smaller share of this year's inc While some analysts expect profit handsets and appliances to make up the shortfall, the flat-panel busine highly cyclical. Unless prices recove the second half of this year, LG may have the cash for investment neede stay ahead of rivals. In handsets, I counting on its early strength in phones to help it capture a growing s of sales, but Japanese manufacturers targeting the same market and will be midable rivals.

Some say LG may end up bein strong No.2 in Korea, the role Jap Matsushita Electric Industrial—r er of Panasonic products—play Sony. "Being Korea's Matsus isn't such a bad place be," says Choi Dong J

vice-president at Teletech, Ko No.4 han maker. No

That's not kind of talk wants to h But wher LG ends up

the rankings, global rivals l another fast-moving Ko player to contend with. ■

—By Moon Ihlwan in S with Cliff Edwards in Las V and Roger Crockett in Chi



VALUE ADDERS

Designers are key

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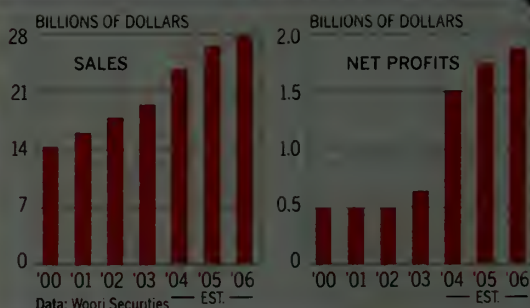
DESIGNERS

DESIGNERS

DUST MIGHT: THE ROBOKING



LG: GIANT IN THE MAKING



HANDSETS: BIG BUDGET

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EDITED BY ROSE BRADY

So Much for China's Great Healer'

WHEN HE ENTERED OFFICE TWO years ago, Chinese President Hu Jintao quickly raised expectations among people looking for kinder, gentler policies from Beijing. During the SARS epidemic in early 2003, Hu seemed to give China's state-owned media more room to report honestly on the country's health problems. At the

same time, Hong Kong's political activists hoped Hu would prove more liberal than his predecessor, Jiang Zemin, in allowing the democracy to develop in the city. And Taiwan's leaders were looking for signs that he would be less hostile than Jiang, who refused to deal with Taiwanese President Chen Shui-bian and sent cross-strait relations into a deep freeze.

But as Hu prepares to take center stage at this year's session of the National People's Congress (NPC) in March, it's clear that he is living up to his billing as China's Great Healer. Indeed, on Taiwan, he "will be even tougher than Jiang," says Richard W. Hu, a politics professor at the University of Hong Kong. President Hu is keeping the pressure on Chen by readying a new anti-secession law. Beijing also has shown no interest in easing up on dissidents or in loosening restrictions on the media. Hu has ruled out democratic elections for Hong Kong's next leader.

Hong sentiment

WHAT'S BEHIND the hard line? For starters, Hu is still consolidating power. While his supporters are losing patience, Hu is relatively new to the top job and hasn't yet exerted complete control over the Communist Party. Moreover, nationalist sentiment is so strong among party officials and ordinary people that Hu cannot be seen as giving ground in key areas. That's why tensions have been rising with Japan, where Prime Minister Junichiro Koizumi has been pushing for a more assertive defense policy and poking neighbors by visiting a shrine honoring Japanese, including war criminals,

who died in World War II.

The most emotional issue is Chen's attempt to further distance Taiwan from the mainland. "I don't think there's any support in the Chinese elite for anything other than a hard line on Chen," says Andrew J. Nathan, a Sinologist at Columbia University. Hu has two approaches to Taiwan, notes Shi Yinhong, a political scientist at People's University in Beijing: "On the one hand, there is the hard line aimed to deter Chen Shui-bian's actions toward independence. On the other hand, the Chinese government wants to show its will to take efforts toward peaceful reunification." Beijing recently proposed direct flights from China to

Taiwan for mainland-based Taiwanese traveling during February's Lunar New Year.

But Hu is also championing the anti-secession law, which would allow the government to punish actions contributing to Taiwan's independence. Many Taiwanese fear that, down the road, Beijing could use the law to justify military action.

"This has changed the status quo," says Philip Yang, director of the Taiwan Security Research Center in Taipei, who notes Hu's worrisome track record when dealing with "splittists." For instance, as governor of Tibet in 1989, Hu declared martial law to suppress support for the Dalai Lama.

With China's influence growing from Asia to the Americas, Hu seems to feel little external pressure for political reform at home. Optimists looking for him to promote a new, more open China should settle in for a long wait. ■

—By Bruce Einhorn in Hong Kong, with Dexter Roberts in Beijing and Matt Kovac in Taipei



TOUGH GUY Hu is taking a hard line on Taiwan

GLOBAL WRAPUP

AN AMERICAN CHIEF FOR ISRAEL'S CENTRAL BANK

ISRAEL'S FINANCIAL markets welcomed the nomination of Citigroup Vice-Chairman **Stanley Fischer** as governor of the **Bank of Israel**, the country's central bank. The Tel Aviv stock index rose 1%, to an all-time high, after the decision was announced on Jan. 9.

A former economics professor at Massachusetts Institute of Technology and onetime first deputy managing director of the International Monetary Fund, Fischer, 61, is expected to push for greater competition in the banking industry as well as a reduction in Israel's government sector, which accounts for more than 50% of gross domestic product.

Israeli stocks rose after Fischer was appointed

Fischer may also serve as a goodwill ambassador for Prime Minister **Ariel Sharon** and Finance Minister **Benjamin Netanyahu** as they try to raise funds to help pay for Sharon's plan to withdraw settlers from Gaza and part of the West Bank later this year. The cost of relocating some 20,000 Jewish settlers is estimated at \$1.2 billion. Israel needs funds from international sources if it is to keep Netanyahu's budget deficit target of 3.5% of gross domestic product this year. Fischer is also likely to advocate more economic development for the Palestinian territories.

Born in Zambia, Fischer has long had ties to Israel. As a young man he worked on a kibbutz, and in the 1980s he advised the Israeli government on defeating hyperinflation.

Hydrogen Cars Are Almost Here, But...

There are still serious problems to solve, such as: Where will drivers fuel up?

AT THE JANUARY AUTO show in Los Angeles, U.S. car enthusiasts got their first look at the H2R, a race car from BMW. Building it took just 10 months, but the race it's designed to win will last for the next 10 years and beyond. It's the race to stem pollution from vehicles that burn gasoline and diesel fuels.

The H2R runs on hydrogen, the gas that lights the sun. All carmakers are scrambling to harness this clean fuel, driven by long-term worries about oil supplies as well as environmental harm. Washington and other governments share the concerns.

When it comes to hydrogen vehicles, most car companies are counting on little under-the-hood chemical refineries known as fuel cells. Trouble is, a fuel-cell system powerful enough for a car would add roughly \$100,000 to sticker prices today. And then there's an even tougher problem: Where would drivers get the fuel? Fewer than 100 filling stations in the whole world now pump hydrogen. So it could be a couple of decades before fuel-cell cars become popular enough to make a dent either in pollution or in petroleum consumption.

BMW is taking a shortcut that addresses these issues, at least in part. Its H2R race car has an ordinary internal-combustion engine—but it burns hydrogen. It's basically the same engine used in the carmaker's 760i luxury sedans. Running on hydrogen, it develops 286 horsepower and propels the H2R from from zero to 60 mph in under six seconds. And the car hit 187 mph last September at the Miramas racetrack in France. "The message we wanted to send is that you can have fun driving and be environmentally conscious at the same

time," says Tom Purves, CEO of BMW of North America LLC.

As for the dearth of hydrogen filling stations, that ceases to be quite as big a problem. The same BMW engine can run on either hydrogen or gasoline, so simply adding a second fuel system can create a bi-fuel car. For daily trips around town, you would burn hydrogen to minimize urban pollution, says Anton Reisinger, manager of BMW's hydrogen program. "But out on the motorway, you could punch a button and run on gasoline." If a trip on hydrogen goes beyond that fuel's 215-mile range, he adds, the car would automatically switch over to gasoline, giving you up to 500 more miles.

The downside to burning hydrogen in a combustion engine is that it produces some pollution—a small amount of nitrogen oxides (NOx). Fuel cells, on the other hand, spew out nothing more noxious than water. But BMW asserts that its out-the-tailpipe NOx levels will be well below even California's strict Super Ultra Low Emission Vehicle standard.

HOT CAR BMW'S
hydrogen-burning
H2R hit 187 mph
on a racetrack

Another consideration is that BMW fuel cars will use liquid hydrogen, which must be kept very cold, below -423°F. The car's onboard cryogenic system takes care of this automatically. But if the vehicle isn't started up for three or four days, Reisinger, the liquid will begin to boil and hydrogen gas will escape through

Making Hydrogen Affordable

By 2010, the world could start producing hydrogen that would cost as little as \$1.50 per kilogram—equal to the energy of one gallon of gasoline:

ELECTROLYSIS

(Uses electricity to split water into hydrogen and oxygen)

Estimated cost using high-volume techniques:

\$2.00/kg

Estimated cost for smaller, filling-station systems:

\$2.50/kg

BIOMASS

(Taps agricultural and forestry waste for hydrogen)

Estimated cost using heat treatment at energy farms and regional centers:

\$2.60 TO \$2.90/kg

LIQUID FUEL

(Extracts hydrogen from fossil fuels, including liquefied coal)

Estimated cost in filling stations and in vehicles:

\$1.50/kg

Data: Energy Dept



That, however, sounds like a bigger myth than it actually is. Despite persistent myths, hydrogen is less dangerous than gasoline. It disperses quickly, so when a container leaks explosions aren't next to impossible.

When will zippy bi-fuel BMW 7 Series cars show up at dealers? It's not a sure

WHERE'S THE POWER?

America's green resources can be tapped to produce hydrogen



bet, but BMW CEO Helmut Panke says he plans to put small numbers of them on the road, probably in Europe, within three years. A U.S. launch is more likely to happen around 2010.

By then, there could be multiple hydrogen filling stations serving major cities. The German government is sponsoring development of filling stations with their own hydrogen generators. That way, the lack of hydrogen pipelines and delivery trucks won't hold back the early transition away from gasoline and diesel to hydrogen cars—and to the ultimate goal of pollution-free fuel cells.

The hydrogen comes from a familiar resource: water. Here's how it works. Water molecules are split into their hydrogen and oxygen constituents by electrolysis, or by shocking them with an electric current. Then, after the hydrogen makes a trip through a fuel cell, it recombines with oxygen in the air and reverts back to water. Refueling stations with electrolyzers have

been built in Berlin, Hamburg, and Munich. And others have been installed as part of the Clean Urban Transport for Europe program in Amsterdam, Barcelona, Reykjavik, and Stockholm.

Hydrogen filling stations are also getting sprinkled across the U.S. Last April, the Energy Dept. said it would spend \$190 million over five years if industry chipped in a similar sum to build hydrogen-and-gasoline stations and other infrastructure projects. Results weren't long in coming. In November, Shell Oil Co. and General Motors Corp. cut the ribbon on a new hydrogen station in Washington. It's just the first of a string of stations between the capital and New York, says outgoing Energy Secretary Spencer Abraham.

In California, Energy has awarded a contract for the construction of two dozen stations to a team led by Air Products & Chemicals Inc. The company has already

A BMW "bi-fuel" car could be on sale by 2008

built 30 hydrogen stations around the globe and is the No. 1 producer of hydrogen. (The fertilizer and chemical industries consume millions of tons of the gas each year.)

Not to be upstaged, California Governor Arnold Schwarzenegger last spring called for a

"hydrogen highway network" by 2010. He envisions at least 150 fuel stops at regular intervals along major highways. The California Fuel Cell Partnership, composed mainly of transportation agencies and carmakers, has so far built 13 hydrogen stations, and the group has more on the drawing board.

BIOMASS: THE TICKET?

SOME OF THE UPCOMING fuel stations may also have water-electrolysis systems. However, while that technology makes sense in Europe, where gasoline is twice as expensive, it's not so attractive in the U.S. Electrolysis takes a lot of electricity. It costs at least \$2.50 to produce a kilogram of hydrogen, which contains the same amount of energy as a gallon of gasoline. But the next generation of wind turbines and solar cells could supply cheaper electricity and make electrolysis more feasible for certain areas of the U.S. (map). Germany is already experimenting with wind-powered electrolysis at filling stations. Energy's goal for hydrogen from water is \$2 per kilogram by 2010.

In the U.S. heartland, biomass is the long-term ticket. This refers to leftover crop plants plus lumber and logging waste. Coaxing biomass to give up its hydrogen now costs more than \$3 a kilogram. But researchers expect to shrink that to \$2.60 around 2010. A few years later, hydrogen could compete with gasoline.

Total up all the potentials, and the U.S. has more than enough domestic resources to supply the energy it needs to replace all automotive fossil fuels with hydrogen—using renewable resources only. So it would no longer be necessary to extract hydrogen from finite supplies of natural gas, which is the source of 90% of hydrogen today.

Once hydrogen is bountiful, says Raymond Freymann, BMW's managing director of research and technology, "we can go to the mono-fuel engine and not only extend the range [of the vehicle] but also improve the performance." So the H2R's 187 mph and 6-second acceleration may be just the start. But it seems like a good beginning. ■

—By Otis Port in New York

EDITED BY
ADAM ASTON

INNOVATIONS

Robo-pharmacist and toxic lawsuits

» Mobile robot workers have already rolled into hospital wards. But where early medibots were little more than orderlies—shuttling records, samples, and drugs around the hospital—the next generation will do more to save lives. Cincinnati Children's Hospital Medical Center is the latest of a handful of institutions to install a fridge-sized robot that can prepare up to 300 custom-mixed syringes every hour. Made by ForHealth Technologies, the \$700,000-plus system uses bar-code tracking, machine vision, and weight-based quality checks. This should help slash the incidence of medication errors. Just don't ask it for advice.

» The Environmental Protection Agency's beleaguered Superfund program was dealt



another blow last month. On Dec. 13 the U.S. Supreme Court nixed the right of companies that voluntarily clean up toxic wastes on acquired sites to sue previous owners and polluters for a share of the costs. That ruling left open the possibility for similar suits under another part of the Superfund Act. But experts say the decision will mean fewer voluntary cleanups, especially on sites deemed a low priority by the EPA.



IMAGING

TAKING LESSONS IN OPTICS FROM THE OCTOPUS

TODAY'S CAMERA lenses share a basic flaw. Because the lenses are curved, images become unfocused at the edges. To correct the blurriness, high-quality cameras use up to eight lenses—a costly fix. Now, inspired by octopus eyes, scientists have achieved supersharp focus with a single, cheaper plastic lens.

The sea creatures have evolved a lens structure several times stronger than a human's. Octopus lenses are made of many thin layers of varying densities. As light moves from one layer to another, it bends and focuses. Following this

model, Eric Baer, a polymer scientist at Case Western Reserve University, and a team from the U.S. Naval Research Laboratory in Washington stacked up hundreds of thousands of superthin plastic sheets of varying densities. The result is a defect-free lens thin enough to fit onto small cameras, surgical devices, and other compact gizmos. Baer now plans to create a flexible, zoomable version. With several parties interested in licensing his invention, Baer thinks it could be on sale within five years. —Burt Helm

PATENTS

FOREIGN STUDENTS FEEL A CHILL

STUDENTS BORN abroad fill most of the seats in graduate-level science and engineering programs in the U.S. Yet last fall, enrollments of new and returning foreign students at most major grad centers fell. The trend confirms fears that foreign students are shunning the U.S., partly because of September 11-related visa hassles and a growing sense that the U.S. is less hospitable to foreign students.

Economists are trying to quantify the economic effects of this falloff. A study by researchers at University of Colorado at Boulder and the World Bank finds that a 10% rise in foreign grad students in the U.S. would bump up patent applications by 3.3%. Notably, patents granted to universities would grow by 6% and to non-university bodies by 4%.

It follows that a shrinking number of foreign-born science PhD and engineering degree candidates could lead to fewer new patents. That's bad news for an innovation-driven economy.

MEDICINE

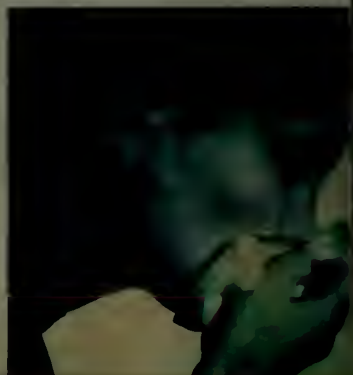
COMING SOON A FLU VACCINE FOR ALL SEASONS?

BIOTECH STARTUP NexBio has a plan to avoid flu-vaccine shortages such as the one that left so many Americans unprotected this year. Animal and other studies demonstrate that NexBio's experimental drug Fludase could be effective against most influenza strains, including avian flu. If the "prevent-all" vaccine proves viable, the development could attract other pharmaceutical companies that have shunned flu research due to the requirement of cooking customized vaccines every year. Only two major vaccine makers supply the U.S. market.

Fludase's formulation is designed to disrupt the virus's normal life cycle. The vaccine blocks a key receptor on the surface of the virus in the air passages of animals that inhale the virus. Without the receptor, the virus can't ensconce itself, replicate, and spread.

NexBio says the vaccine is stable enough to be stockpiled for several years. That makes it attractive to the U.S. government, which is funding the startup with biodefense grants and hopes to create stores of vaccine to guard against the threat of pandemics and potential bioterrorism attacks. NexBio intends to start human clinical trials this year.

—Arlene Weintraub





What If Companies Messed Up?

Massachusetts' William Galvin is pushing for admissions of guilt in fraud cases

WHEN COMPANIES settle big lawsuits, they rarely own up to having done anything wrong. Instead, officers sign a carefully worded legal document in which the corporation neither admits nor denies misconduct. This vague language paves the way for the charade of CEOs spending hundreds of millions of dollars to make lawyers and plaintiffs' lawyers go home—then holding press conferences in which they suggest that, despite the enormous payoff, the company was

victimimized by overzealous opponents.

Massachusetts Secretary of the Commonwealth William F. Galvin wants to put an end to this now-familiar legal fiction. He's calling on fellow regulators to forgo the "neither admit nor deny" language in cases of clear fraud and strike tougher deals in which companies are forced to admit that they engaged in unlawful conduct. That's just what he did in the fall with Franklin Templeton Investments and last April with Putnam Investments—two mutual-fund companies that allowed privileged investors to make rapid-fire trades that worked to the disadvantage of long-term stakeholders.

GALVIN Right now securities law is a game of "touch football"

This is a potentially revolutionary idea. For companies, the difference between admitting miscon-

duct and fudging the issue is vast. If more regulators start following Galvin's lead, it would be easier for plaintiffs' lawyers to win fraud lawsuits. Insurers might balk at providing coverage for directors and officers. And managers at the periphery of illegal activity would have a harder time holding on to their jobs.

REFORMIST IMPULSE

GALVIN'S GOAL is to inflict a punishment that truly stings—unlike monetary fines, which can be a fraction of illicit profits and thus can easily be waved off by aggressive execs as a cost of doing business. It's the same reformist impulse that earlier this month motivated New York State Comptroller Alan G. Hevesi, trustee of the New York State Common Retirement Fund, the lead plaintiff in an investor lawsuit against WorldCom Inc., to insist that the company's directors use personal funds to settle the case. "How seriously are you going to take securities law if it's going to be a game of touch football?" says Galvin. "The only way you're going to get significant change is when you start treating things seriously—and an admission of guilt is serious."

The Securities & Exchange Commission is now studying whether it should press harder for companies to acknowledge wrongdoing. Commissioner Harvey J. Goldschmid expects the five SEC commissioners to discuss the issue by March. But while Goldschmid is no fan of the current system, he worries that corporate defendants would fight far more aggressively if they were routinely forced to acknowledge breaking the law. That in turn would drive up the cost of investigations and limit the agency, which brought 639 cases in the last fiscal year, to pursuing a fraction as many of them. If the SEC had to push for broad admissions, "it would be a terrible waste of government resources," says Goldschmid. "We'd have to go to trial. The stakes would be so large."

Indeed, the whole cost-benefit calcula-

We Did It

When companies are forced to acknowledge wrongdoing, the consequences can be serious

PRIVATE SUITS

If a company admits it has acted improperly, it's easier for plaintiffs' lawyers to make their cases. Potential awards increase, while the cost of pretrial investigation goes down.

INSURANCE

Many directors and officers policies limit coverage in the event of crime or fraud. Admissions could expose companies, as well as managers and directors, to increased liability.

PUBLIC OPINION

Now it's common for CEOs to blame their woes on overzealous opponents. Admissions set the record straight. There's no hiding behind ambiguity about whether or not a company misbehaved.

tion for most corporate fraud cases would change if regulators ceased allowing defendants to dodge liability. Under long-standing legal rules, admissions made in governmental proceedings can be entered as evidence in private litigation. This reduces the burden of proof for plaintiffs' lawyers—and in some cases would render companies essentially defenseless as to their underlying liability in related cases. "It's a road map for private lawsuits," says Joel Seligman, dean of the Washington University School of Law in St. Louis.

READ THE FINE PRINT

IN THE PUTNAM and Franklin cases, the degree to which their admissions will help cheated customers is unclear. Despite Galvin's claims about his innovative settlements, both deals contain fine print intended to make it harder for plaintiffs' lawyers to use the confessions in court. Specifically, there are clauses stating that the admissions are solely for the purpose of settlement in the Massachusetts cases. Still, this language does not provide the companies with iron-clad protection, according to John P. Freeman, a professor at the University of South Carolina School of Law.

Above and beyond liability, an equally important concern for companies is insurance. Typical directors and officers (D&O) policies cover some regulatory fines, private settlements, and legal defense costs. But they also contain exceptions for executives who commit crimes or frauds. While insurers are usually willing to pay up in the typical case in which executives avoid a finding of liability, they would have a good argument for withholding payment from managers who acknowledged that they violated the law.

Thus, the consequences of admitting wrongdoing can be severe. But Galvin and others insist the fallout is nothing more than defendants deserve. What's more, the potential benefits of corporate admissions might in some cases outweigh the costs of obtaining them. For one thing, they would put more pressure on boards and top managers to clean house. More important, they would send a clear signal to employees that malfeasance is unacceptable—a message that is all too often undermined when the CEO fails to acknowledge that anybody has done anything illegal. Coming after an era of unprecedented corporate crime, such candor might be a welcome change. ■

—By Adrienne Carter in Chicago, with Amy Borrus in Washington

The Jack Welch Of the Meat Aisle

Former GE exec Larry Johnston brings high tech to troubled Albertsons

THE FIRST QUESTION Lawrence R. Johnston asked when a headhunter got in touch with him three years ago about running Albertsons Inc. was: "What's Albertsons?" But it didn't take long for Johnston, then the chief executive of GE Appliances and often on the receiving end of such feelers, to realize that Albertsons, the nation's second-largest grocery chain, was the opportunity he had been waiting for. His assignments at General Electric Co., especially resuscitating its ailing European medical services business in the late 1990s, had been so challenging that every other job he considered felt as if he would be taking early retirement. Not so at Albertsons. "This one intrigued me because it was very close to customers. It was big. It was complex. And it was broken," he says.

It certainly was. The folksy, family-owned grocery chain that Joe Albertson started in Boise, Idaho, in 1939 had become a \$35 billion dysfunctional mess. The company had botched the introduction of its 1999 merger with Ames Stores Co. "It was clear we didn't know who we were," recalls Paul I. Cordery, a board member since 1987. And while executives were preoccupied with internal battles and lawsuits, Wal-Mart, Safeway, Target, and other discount retailers were eating Albertsons' lunch.

"LARRY CAN LEAD"

JOHNSTON, 56, had been a lifer at GE. He joined in 1972 right after graduating from Stetson University in Florida with a degree in business, distinguished himself early on with his salesmanship, and on a series of increasingly high-profile assignments for two decades, and was within reach of Jack Welch's job.

BIO

Lawrence R. Johnston

Greater efficiency allows us "to connect better with customers"

BORN Aug. 29, 1948, in Corning, N.Y. Father sold GE appliances at a retail store. Mother earned her BA at age 72.

EDUCATION BA in business administration, Stetson University, 1972

CURRENT POSITION Chairman, president, and CEO of Albertsons since April, 2001

FIRST JOBS Paperboy, KFC cook, and door-to-door Christmas card salesman

CAREER PATH Started in 1972 as a sales trainee in GE's appliance division. Later, promoted to president and CEO of GE Medical Services European division in 1995. Served as president and CEO of Appliances, a \$6 billion business from 1999 to 2001.

FAMILY Married while in college; two daughters, one son, four grandchildren.

AFTERHOURS Sang in a barbershop quartet.





mostly because of his record at the cal services division. Welch dis-
ed him to Paris in 1997 to fix the
ess, which was losing \$100 million a
or dump it.

less than three years, the division
making a \$100 million operating
. According to Welch, Johnston suc-
d because he quickly realized his
task was reenergizing the employ-
This was a cynical group of French
German engineers," Welch recalls.
he engaged them incredibly." Every
h Johnston traveled to a different
pean city, conducting sales meetings
e mornings and taking his team to
hospitals in the afternoons. And at
s he studied French. "Larry can lead
e over the hill," Welch says. "He put
the map in Europe."

it's safe to say that Johnston came to
tsons in April, 2001, with an idea or
about how to tackle the company's
ems. First, natch, was to make it op-
more efficiently. Johnston is cutting
\$1 billion in costs while spending
er billion to upgrade technology—
the supply and distribution system to
neckout stands. He closed 500 un-
able stores. And he has introduced a
managerial and financial discipline,

UP TO DATE IN IDAHO

Johnston at the first
Albertsons, in Boise.
A hand scanner lets
buyers add as they go

including Six Sigma, to
the 230,000 employees.

But he also knows
that Albertsons—or any
retailer, for that mat-
ter—can't take on Wal-
Mart with greater effi-
ciency and lower prices
alone. So Johnston has decided that Al-
bertsons will have to make grocery shop-
ping something it not always is: quick and
easy. If all goes as planned, in 18 months
shoppers in all 2,500 stores will use hand-
held scanners that are connected to a com-
pany data base and a global-positioning-
satellite system. The devices will read
product labels and keep a running tab;
they can direct customers to the shortest
path to their groceries and alert them to
special offers based on past purchases or
that a prescription is ready. At the exit, the
scanner charges the total to a credit card.
No checkout line. No waiting. "The new
technology not only allows us to be more
efficient, but it also allows us to connect



better with customers at the most intimate
levels." And this, Johnston hopes, will help
Albertsons finally boost sales.

Because it isn't happening any other
way. So far, Johnston is squeezing profit
out of the grocer but not through sales
growth. The 18% rise in third-quarter
earnings was due mostly to lower costs.
Same-store sales growth stayed flat, at
0.3%. "Albertsons sales momentum re-
mains very uninspiring," says Goldman
Sachs & Co. analyst John Heinbockel.
Meanwhile, Wal-Mart could well generate
up to \$162 billion annually in "super-
market-type" sales in three years, accord-
ing to retail consultant Retail Forward
Inc. That's more than the combined re-
venues of the top three national grocers:
Kroger, Albertsons, and Safeway.

WAR WITH THE WORKERS

JOHNSTON IS ALSO dealing with the lin-
gering aftereffects of last year's four-month
strike in Southern California, which cost the
company \$1.2 billion in lost sales and im-
measurable ill will among employees. "You
can't differentiate yourself from Wal-Mart
through high-quality service at the same
time you go to war with your workforce
demanding they give up their benefits,"
says Patrick J. O'Neill, executive vice-presi-
dent of the United Food & Commercial

Workers union.

You might think that
Johnston, who likes to
talk about motivating
employees, would have
some regrets about the
strike. But it doesn't ap-
pear so. "[The strike]
was very costly, but [the
settlement] was one of
the best investments
our company ever
made," he says. He be-
lieves his tough stand
allowed him to reach la-

bor agreements elsewhere more readily.
That, and direct communication with the
employees. When a union in Chicago was
sitting on a new contract, Johnston decid-
ed to explain the terms in a video he sent to
every worker's home. The contract was ap-
proved by the next deadline.

Johnston is continuing the charm of-
fensive with weekly e-mails to all em-
ployees, monthly live broadcasts, and reg-
ular visits to stores. And he is introducing
a seminar on positive thinking. That's not
something Joe Albertson might have put
much stock in, but then he probably never
imagined that Wal-Mart would one day
be selling milk and eggs. ■

—By Stanley Holmes in Boise, Idaho



INDONESIA
has big offshore
drilling oper

On a Fast Boat to China?

Why Unocal—and its rich reserves—may be snapped up

AT FIRST GLANCE, UNOCAL Corp. doesn't seem much of a prize. The El Segundo (Calif.) energy company—the nation's eighth-largest—has seen its oil and natural gas production fall steadily during the past decade. Its stock price has badly trailed its peers. Yet on Jan. 6, Unocal shares jumped 10% when rumors began circulating that the company might be acquired by China National Offshore Oil Corp. (CNOOC), one of the three largest energy companies in China and, like most other big outfits there, controlled by the government.

Unocal and CNOOC wouldn't comment on the reports. And there is considerable skepticism among analysts about whether CNOOC has the financial heft or management depth to pull off such an ambitious deal, which at some \$13 billion would be the largest acquisition yet of a U.S. company by the Chinese. But the news highlights a central dilemma of the oil business: Investors want to see growth in oil and gas production. Yet companies often get penalized when they try to develop risky new fields rather than just acquiring existing ones. That's why Unocal's market value trails that of other big oil companies—and explains why it may get snapped up. The company, with

large reserves of oil and gas in Indonesia and Thailand, could prove valuable to China, whose thirst for energy is outracing its domestic output. Or, Unocal could become the target of a cash-rich integrated giant like BP PLC.

How could Unocal go from ugly duckling to sought-after swan? The company has lagged its rivals in producing oil and gas. According to investment bank John S. Herold Inc., it is also below average in generating net income per barrel and replacing reserves, and has higher exploration expenses. However, Unocal still possesses tremendous assets—nearly 1.8

billion barrels of oil and natural gas reserves, half of them in the Far East. Some of its long-term bets are beginning to pay off: After years of decline, the company's oil and gas production may be climbing this year. And thanks to surging prices, Unocal remains solidly profitable. Analysts expect it to earn \$1 billion in 2004—up 55% from a year earlier. Its stock price should reach \$7 billion.

Founded in 1890 as Union Oil of California, Unocal repelled a takeover attempt in 1985 from corporate raider Boone Pickens, but was left staggering under a load of debt. In the mid-1990s,

Eyes on the Prize

These major projects coming online may make Unocal an attractive takeover target in energy-starved Asia:

INDONESIA Unocal discovered the country's largest oil and gas field, Attaka, in 1970. Today it operates 11 fields off the coast of East Kalimantan, including the West Seno deep-water field. Substantial reserves of natural gas are being exported through the Bontang liquefied natural gas facility, the world's largest.

THAILAND Unocal natural gas powers 30% of Thai electricity production. A new pipeline in 2006 will increase output to 850 million cubic feet per day. Oil production from the nearby Pattani field should double this year, to 15,000 barrels a day.

AZERBAIJAN Unocal is a 10% owner of a consortium that controls 4 billion barrels of oil in the Caspian Sea. Fields that are ramping up this spring should take Unocal's share of production from 18,000 barrels per day to 100,000 by 2008.

Data: Unocal, Petre Park

Unocal went through a strategic shift. Many rivals were merging or acquiring existing oil and gas fields, Unocal was selling many of its less profitable assets to focus on big new fields overseas and in the deepwater Gulf of Mexico. Fortunately for Unocal, its Asia operations were largely untouched by the recent tsunami. Those fields can take years to develop, however, and often face dissentments along the way. Take Unocal's giant West Seno field off the coast of Indonesia's East Kalimantan. Upon its discovery in 1998, a Unocal executive boasted it would be the first of a "string of fields" in the region. It turned out to be more like a millstone. Located under 1,000 feet of water, West Seno was the company's first deepwater project. Unocal had to build two floating platforms with 10-inch steel pipes snaking 50 miles to shore, costing more than \$400 million.

GUSHING

BEFORE IT GOT DRILLING, Unocal found the flow of oil disappointing. The company had hoped horizontal drilling techniques would boost production across the shallower parts of the reservoir. That helped boost production to 100,000 barrels a day by the end of last year, but it may cause production to peak earlier than planned. In September the company announced that construction had come in too high and that it would not pursue a second phase.

Partly because of the challenges of drilling on new fields like West Seno, Unocal last summer changed its method of forecasting production growth. Unocal now gives out only estimates that it has a 60% certainty of meeting, compared with 80% certainty before. And it forecasts production more than one year in advance. For Unocal's output is expected to decline by 10%, to 406,000 barrels per day, the worst among the 11 largest U.S. and foreign oil producers, says brokerage firm Edward & Jones Inc. "Our history has not been all that stellar in terms of meeting production targets," Unocal Chairman and CEO Charles R. Williamson told investors in August. He declined to speak to *BusinessWeek* for this article.

Unocal may yet turn things around. It has several big projects just now ramping up, including a 10% interest in a 4 billion-barrel field in the Caspian Sea. "This is a company that has disappointed in the past," says Steve Enger, an analyst at Parkman & Co. "But it could see production growth of 7% this year and 10% a year beyond that." That's exactly what may attract the suitors. ■

by Christopher Palmeri in Los Angeles

LEGAL SETTLEMENTS

A Milestone For Human Rights

In the mid-1990s, reports emerged out of Burma that villagers in the remote Yadana region had been forced by the military to clear jungle for the construction of a \$1.2 billion natural gas pipeline. The allegations were horrendous: To round up workers for the project, the Burmese military had resorted to torture, rape, and murder to enslave villagers, even throwing one woman's baby in a fire after killing her husband. Before long, U.S. human rights groups had filed suit against Unocal Corp., based in El Segundo, Calif., one of the four pipeline partners, on behalf of 15 unnamed Burmese villagers.

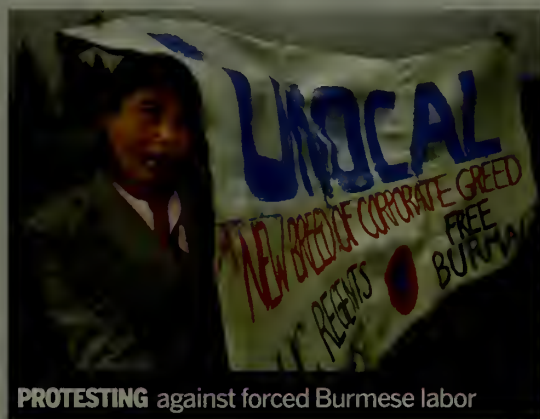
Now, after years of courtroom sparring, Unocal has quietly agreed to settle the suits, one filed in California state court and another in the U.S. District Court in Los Angeles. Although a court gag order has

prevented multinationals to protect their workers against abuse by repressive regimes. While the courts didn't issue a binding precedent in the case, the fact that Unocal has apparently agreed to cough up such a large sum after adamantly denying responsibility strengthens a major strategy of human rights groups. The Unocal case "shows that corporations have both direct and indirect human rights responsibilities," says Susan Aaronson, director of globalization studies at the Kenan Institute, a Washington think tank.

Unocal is the first of a series of U.S. multinationals to face allegations that they acquiesced in or benefited from human rights violations, committed mostly by authoritarian governments. Other defendants include ExxonMobil, Coca-Cola, Drummond, Occidental Petroleum, and Del Monte Foods. The companies are

all fighting the suits. The cases hinge largely on a 1789 statute, the Alien Tort Claims Act, that allows foreign litigants to seek damages in U.S. courts for crimes against "the law of nations," generally murder, torture, kidnapping, and slavery. Last June, the U.S. Supreme Court upheld the use of the law against U.S.-based companies.

U.S. corporations and the Bush Administration have argued that companies shouldn't be held to a "vicarious liability"



PROTESTING against forced Burmese labor

kept many details under wraps so far, insiders say that Unocal will pay about \$30 million in damages to settle the cases. The award will include money for the 15 plaintiffs and for a fund to improve living conditions, health care, and education in the pipeline region. Unocal has declined further comment, although it has repeatedly denied any involvement in the abuses. Nevertheless, the company has acknowledged that the Burmese military, which has ruled the nation since it deposed the elected President in a 1988 coup, abused some workers.

The settlement may mark a milestone in human rights advocates' struggle to use U.S. courts to force American

standard but should instead be held blameless unless involved directly in the crimes. But that defense doesn't seem as promising now. The Unocal case was headed for a California state jury on just such an indirect connection to the Burmese crimes when the company abruptly settled in mid-December. The federal case, still in the motions phase, appeared headed for a jury as well, says Terry Collingsworth, executive director of Washington's International Labor Rights Fund, one of three groups representing the Unocal plaintiffs. Now, U.S. companies may feel similar pressure to cut their losses and settle such suits.

—By Paul Magnusson in Washington

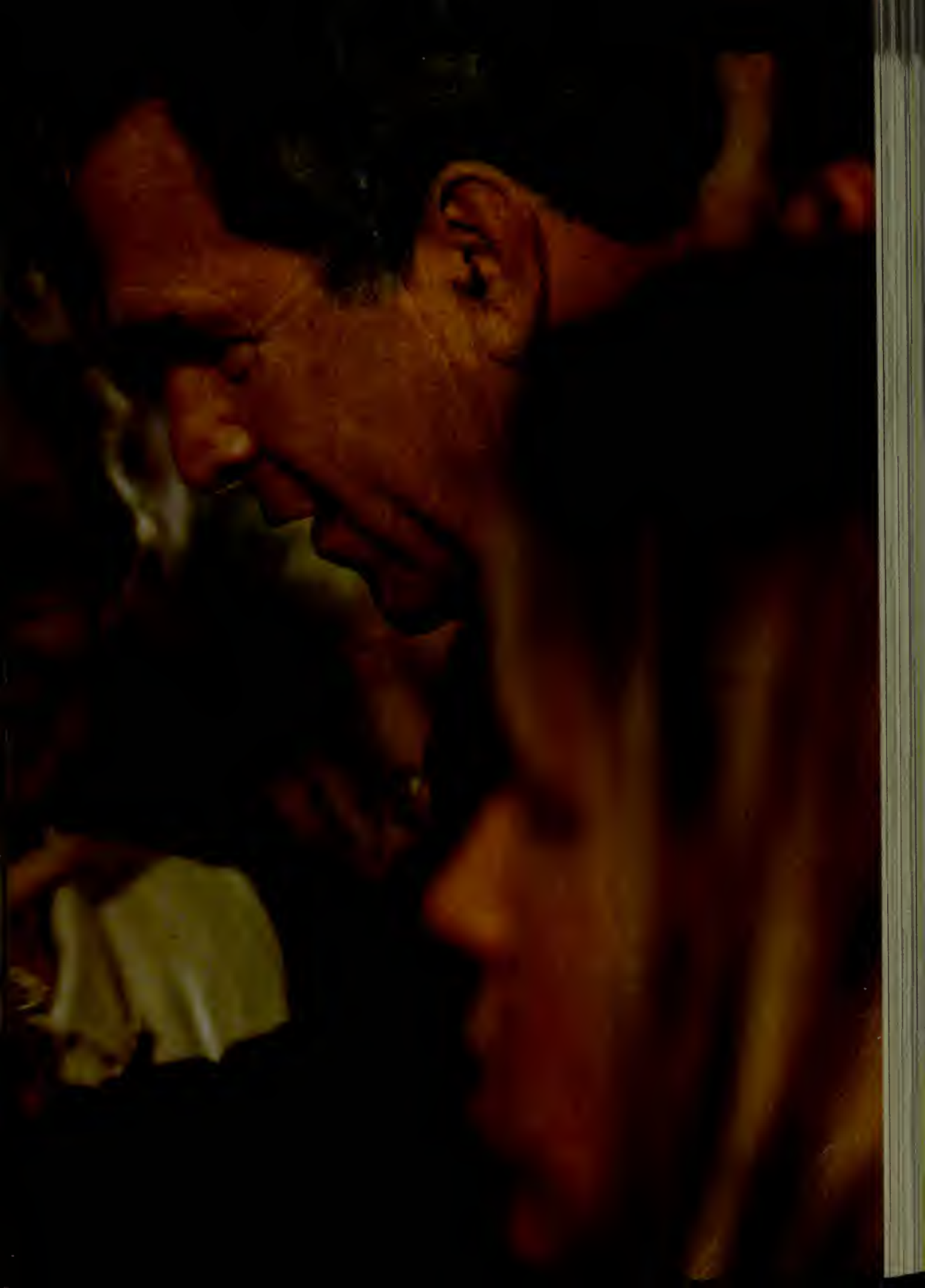
SPECIAL REPORT

SOCIAL SECURITY

Are Private Accounts A Good Idea?

NOT TO WORRY Bush is reassuring seniors that their benefits won't be touched

JARED LAZARUS/AFP/GETTY IMAGES



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BY AARON BERNSTEIN

TO GIVE AMERICA'S struggling seniors a life-line out of poverty, Franklin D. Roosevelt 70 years ago established the Social Security system. The program was never intended to be particularly generous—and even after increases over the decades, the average check totals just \$14,000 a year. Yet Social Security remains a mainstay for America's 36 million seniors; two out of three of them count on it for half their income.

Now, a cash squeeze endangers Social Security's future, as the huge Baby Boom population heads into retirement. If nothing is done, the system may only have enough money to pay today's young workers about two-thirds of their benefits when they retire. So President Bush and other free-market advocates are suggesting the most sweeping change to this core social program since its inception, based on a simple premise: Let the stock market help fix it.

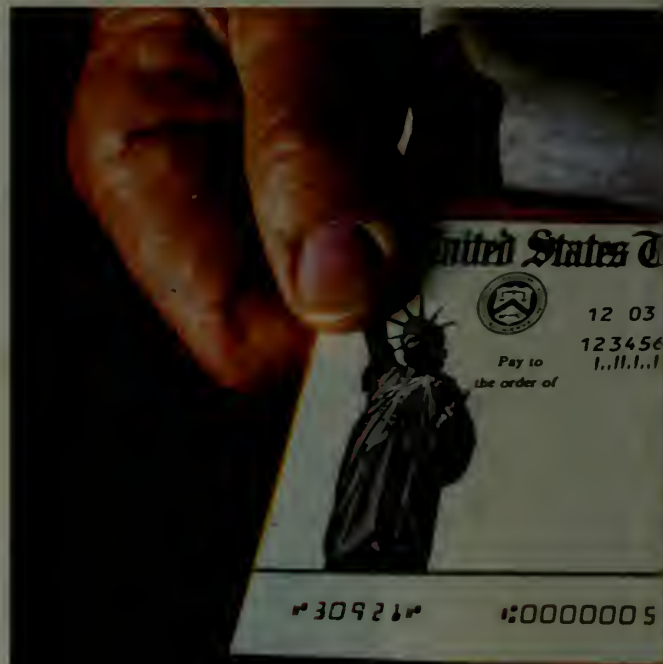
On Jan. 11, Bush kicked off his new campaign by telling a town hall meeting that younger workers should be able to take some of their payroll tax and "set it aside in the form of a personal savings account." Social Security only provides returns of about 2% a year after inflation, and private accounts, says the President, could top that easily if they were invested even partially in stocks. Explained Bush at a press conference back on Dec. 20: "Over time, that rate of return would enable that person to...make up for the deficiencies in the current system...and more likely get that which was promised."

Is he right? Are private accounts really a good idea? The short answer is, they could be—but only if Americans are willing to wait several generations for the higher returns to make up for Social Security's expected shortfall. The gap is so large—\$3.7 trillion in today's dollars—that even if the stock market matched its historical average, private accounts wouldn't fill the gap for something like 90 to 100 years. And that doesn't even count the extra \$1 trillion to \$2 trillion in transition costs required to set up such accounts.

"NOT A MAGIC BULLET"

STILL, PRIVATE ACCOUNTS HAVE THEIR APPEAL. They could be a way to encourage savings. They could partially prefund a system that is now pay-as-you-go. Another plus: the nest egg that builds up, something older Americans may be able to pass on to their heirs.

The details of the plan that the President will ultimately ask the country to consider are very much in flux. Now that Bush has put fixing Social Security at the top of his domestic agenda, there's a profusion of proposals across the political spectrum, and horse-trading between Republicans and Democrats over the coming year will certainly influence the shape of the final program. For now, Social Security reform is a moving target (page 72).



How to Fix Social Security

The many plans to deal with the predicted shortfall in promised Social Security benefits fall into three main categories

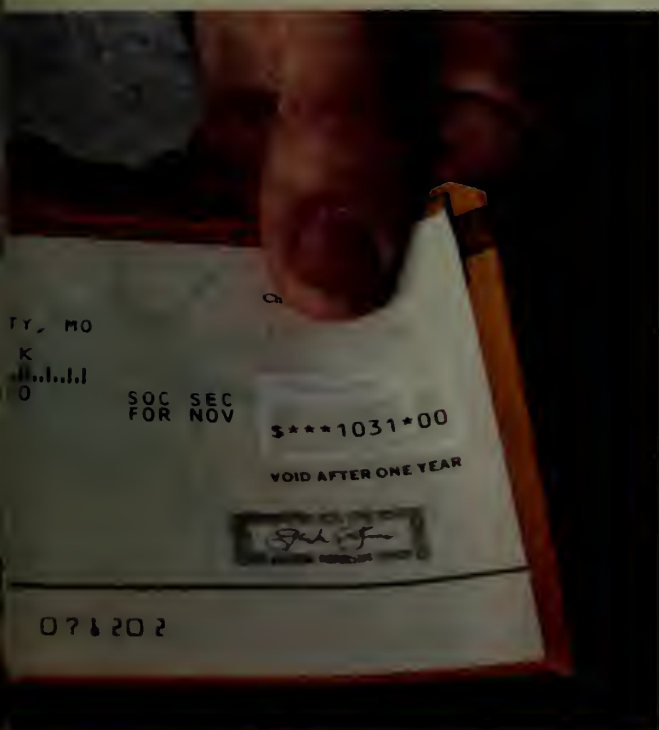
RAISE TAXES, TRIM BENEFITS

Moderates and liberals figure the shortfall could be fixed with some combination of modest tax hikes and some gradual reduction of the benefit.

Hiking taxes Lift the taxable wage base for rate workers and employers each now pay on the \$90,000 of wages. Or raise the taxable wage base to, say, \$150,000. Bush and some Republicans may back this, but Democrats would use the extra revenue to help fund the shortfall, which expires in 2018. It would help fund the shortfall, which expires in 2018. It would help fund the shortfall, which expires in 2018.

Cutting benefits The retirement age is already rising to 67 for those born in 1960 or later and could be extended to 70. A variable adjustment of annual benefits to reflect longer life expectancy would also help.

Even so, the President has pointed repeatedly to the suggestions of his 2001 Commission to Strengthen Social Security. That group's blueprint contains the rudiments of about any of the private-account schemes out there, it's a good starting point to assess how a partially privatized system might play out over the long haul. Its primary plan calls for allowing workers under 55 to divert four percentage points of their 12.4% annual Social Security payroll tax into private accounts.



PRIVATE- ACCOUNT FIX

Tap the power of the market to fill Social Security's \$3.7 trillion shortfall. Private accounts would earn higher returns than U.S. bonds and the system.

Detail: Workers would pay payroll taxes by the dollar and invest the money in individual accounts. The promised benefit would be indexed to inflation. The plan is backed by GOP and opposed by Dems, labor unions, and senior groups.

Private accounts: All payroll taxes would still go to the Social Security fund, but workers would get incentives to invest their income for retirement. Dems like them, but IRA-like savings would not fix Social Security's funding problem.

THE DO-NOTHING APPROACH

Optimists point out that the shortfall won't occur if the U.S. economy and population continue to grow at their historic rates over the next 75 years.

What crunch? Some say the official projections are based on extremely conservative assumptions about economic growth that have been adjusted every year since the mid-1990s' economic and immigration booms. Each time, the crunch date for Social Security has been pushed into the future. Since any shortage wouldn't hit until 2042—or even 2052—why not wait to see what scenario plays out?

Data: BusinessWeek

reducing benefits from today's promised levels. But now, some Administration officials are starting to concede that private accounts can't earn enough to fix all of Social Security's ills. White House adviser Peter H. Wehner made the point explicitly in a memo widely circulated in early January.

If Americans go for private accounts, then, it won't be so they themselves receive the retirement Social Security currently promises. Instead, those working today would be accepting smaller benefits, as would their children when they join the workforce, so that their grandchildren could count on a fully funded system. Says David C. John, a research fellow at the conservative Heritage Foundation who is a leading advocate of private accounts: "It's wrong to say that private accounts can fill Social Security's shortfall. They're not a magic bullet. But do you want to leave the world better for your grandchildren or just tell them to make do?"

THE OWNERSHIP AGENDA

OF COURSE, POLITICS WEIGHS just as heavily as economics in the great Social Security debate. Bush's desire for personal accounts is part of his larger vision of an "ownership society," in which the power of the market is unleashed to better the lives of average Americans. This view motivated the savings- and investment-oriented tax cuts of his first term. It drives his enthusiasm for such ideas as health savings accounts, with their tax incentives aimed at giving Americans more control over a basic aspect of their lives. And it's at the core of his desire for partial privatization of Social Security.

Democrats, deeply at odds with Bush's sweeping ownership agenda, largely oppose schemes featuring private accounts. Instead, they're expected to push for a hike in payroll taxes along with some benefit cuts, though smaller ones than Bush's plan would entail. Of course, there would be no stock-market offset, either. "Maybe we don't have to solve the whole problem right now, since it's still so far off," says Alicia H. Munnell, director of the Center for Retirement Research at Boston College. "But we've got to make a start with some combination of small tax hikes and benefit reductions." Even larger problems loom, she notes, such as Medicare's huge deficit, which is twice as large as Social Security's.

Some critics even argue that stronger economic and demographic growth alone could solve the problem, so we should wait a while longer before taking drastic

Bush aides concede that private accounts can't earn enough to fix Social Security's ills on their own

steps. After all, the \$3.7 trillion shortfall occurs in part from the looming Baby Boom retirement wave and in part from pessimistic projections of a steep slowdown in economic and population growth. But if the U.S. matched its growth rates of the past 75 years for the next 75, there would be no shortfall at all, according to projections by the Social Security Administration (SSA). Paradoxically, "if the pessimists are right, and there's a shortfall, you can't [also] have 7% returns in stocks, so private ac-

a maximum of \$1,000 a year. It also slashes the future growth of Social Security benefits to wipe out the shortfall—relying on the accounts to make up what amounts to only a portion of the difference. Indeed, today's 20-year-olds would see their promised benefit cut nearly in half, leaving them a check for just 15% of their annual income when they retire. Of course, no politician wants to be the first to deliver bad news, so Bush hasn't yet indicated that his plan might involve

participate and would invest prudently by splitting their account 50/50 between stocks and bonds. They would use their earnings to buy an annuity when they retire, leaving a net return of 4.25% a year. (At that rate, the private account of a young worker today would be worth \$149,000 at age 67.) Goss found that average workers after 75 years would wind up with the equivalent of \$1,615 a month in today's dollars, leaving them 20% short of matching the promised \$2,032 benefit. "You can't use private accounts to make up the Social Security shortfall; the hole is just too deep," says Michael Tanner, director of the Project on Social Security Choice at the libertarian Cato Institute in Washington, who nonetheless supports private accounts.

What's more, over time, private accounts would eclipse traditional Social Security. Just look at what average workers would collect (table, page 69). The \$1,615 would come from two sources. The 4% of payroll they had diligently invested in personal accounts would yield \$989, according to Goss. Meanwhile, the 8.4% workers and employers had continued to fork over to the traditional Social Security fund would pay the remaining \$626.

At the same time, the stock market can't provide enough extra returns for private accounts to close the entire gap within 75 years. Look at what would happen to Social Security in the aggregate, rather than from the perspective of an individual. If all workers 55 and younger invested 4% of their pay into a private account, that would create a \$4.6 trillion hole over this time. Assuming a 6.5% annual stock market return on that 4%, however, about \$8 trillion would pile up after 75 years, according to calculations by Dean Baker, co-director of the Center for Economic & Policy Research, a liberal think tank in Washington that opposes personal accounts. Net it all out, and that would still

leave the system \$300 billion shy of plugging the \$3.7 trillion hole. "You can't solve the shortfall without slower benefit growth or some source of added funds," agrees Harvard University economics professor Martin S. Feldstein, a leading privatization proponent.

Remember, too, that none of this includes the \$1 trillion to \$2 trillion in transition costs that would be required to set up private accounts. Because Social Security is a pay-as-you-go system, allowing workers to divert 4% of their pay into private accounts would leave the SSA short of funds to cover current retirees' benefit checks. This cost is by definition transitory, since the diverted money eventually would be put back into the system. After all, as workers with private accounts retired, their check from the traditional Social Security system would be lower, to offset the money

that went into their account. However, that wouldn't happen for several decades, forcing the government to borrow the difference to keep the system afloat in the interim.

The true nature of this cost has ignited an almost theological debate. The Bush Commission plan would require Washington to borrow at least \$160 billion a year in the early years. Since the federal government is already running a \$400 billion-plus deficit, the central question is what the economic impact would be of jacking up Uncle Sam's indebtedness by 40%. The traditional

view: The bond market would hike interest rates, slowing economic growth. Higher deficits or national debt also weigh down a weakened dollar. "If you pile on another \$1 to \$2 trillion to the national debt we've already got, it could ger an economic crisis," warns Massachusetts Institute of Technology economics professor Peter A. Diamond.

Recently, though, Administration officials have begun to argue that since the borrowed money eventually would be paid back, it shouldn't count as an increase to the deficit. Back in the 1980s, economists such as former Council of Economic Advisers R. Glenn Hubbard, now dean of Columbia University's Graduate School of Business, private-account advocates point out that any transition costs would be offset by a corresponding reduction in the U.S. government's long-term debt—leaving little change in its borrowing. "This is different than normal debt because the money is saved, not spent, so the effect on financial markets would be very small," says Feldstein.

ALTERNATE ROUTES

WHILE THE DEBATE MAY SEEM ABSTRACT, the answers. If Washington can sell up to \$2 trillion worth of bonds at essentially no economic cost, leaving them off the federal budget sheet, personal accounts would be much easier to sell politically. But if the money must be accounted for in the federal budget, Bush would have to retreat from his pledge to slash the deficit in half. Either that, or slice other social programs, or hike taxes, which Republicans won't touch.

By contrast, one liberal proposal that has received much attention, from MIT's Diamond and Brookings Institution economist Peter R. Orszag, would make tax hikes its centerpiece combined with benefit cuts in roughly equal proportions suggest raising the cap on the payroll tax, currently set at \$90,000 of income (it increases with average wages each year). The reason: Affluent people are more likely to live longer than Social Security intended. So they're getting more out of the system than they pay into it. They would also lift the 12.4% payroll tax for everyone starting two decades hence. Benefits would come down, though by much less than what price indexation would do. A 25-year-old, for example, would get an 8.6% reduction in the growth of promised benefits.

The most audacious position may be to do nothing at all at least for a decade or so. The \$3.7 trillion shortfall that spurred Bush into action is based on Goss's projections that the U.S. economy will grow at a slower rate over the next 75 years. If inflation-adjusted GDP gains will drop to 2% a year, he projects, the 3% average that has held for the past 75 years. And the force will inch up at a mere 0.35% a year, vs. an historic average of 1.4%. But the SSA has adjusted these numbers every year since the mid-1990s economic and immigration booms, lowering the shortfall and pushing back the crunch date each time.

Goss's reliance on conservative assumptions is perfectly reasonable, especially since no one can really project anything more than 75 years. But his more optimistic scenario, based largely on historic growth rates, shows no shortfall at all. Since the U.S. economy has produced pleasant surprises for nearly a decade, it might be lost by waiting to see if those trends continue. For those unwilling to wait, private accounts will help—even if it's all a matter of patience," says Diamond. "It could take many years for stocks to pay off, and the question is, does one really want to wait that long?" The challenge for private account advocates is to convince Americans that reinventing Social Security for their grandchildren is the right thing to do.

Private accounts are meant to avert a crisis that comes to pass only if growth falls below historic levels

A Hyundai like you've never seen before.

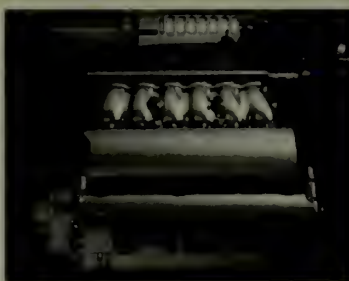
We're investing over a billion dollars here in North America. A new engineering facility in Michigan, a new design and research center and a test track in California. And now, a state-of-the-art assembly plant in Alabama. In the process, we've added thousands of jobs across America. All of it to ensure our unwavering commitment to quality. The result will be a Hyundai like you've never seen before.



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All-new designs, inside and out, from our design center in California.



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The Beltway Battle Ahead



W

BY HOWARD GLECKMAN

HEN GEORGE W. BUSH kicked off his dramatic initiative to create a Medicare drug benefit in 2003, seniors' lobby AARP summoned up all its nationwide muscle to support him. It bought ads, called town meetings, and used a sophisticated telephone system to connect seniors to their representatives in Congress.

This year, as Bush embarks on an even more ambitious crusade—revamping Social Security—AARP is once again calling town meetings, buying ads, and hooking seniors up with their representatives and senators. But this time they are fighting the Administration. “Opposing this is our top priority for 2005,” says AARP CEO William D. Novelli.

And Bush hasn't just lost AARP. While he always managed to enlist a few Democrats for his first-term proposals, he's having no such luck now. The normally fractious minority, still licking its wounds from a dispiriting November election, is nearly united in opposition to allowing workers to shift a portion of their payroll taxes into private investment accounts. Even many loyal Republicans are skittish about touching what has long been considered a third-rail issue. And now, sources say, Federal Reserve Chairman Alan Greenspan is expressing concern that extra bor-

rowing to finance private accounts could raise interest

Those dynamics promise to make the Social Security Bush's toughest legislative slog since he came to Washington in 2001. Unlike his signature tax cuts and Medicare changes, which handed out new goodies to voters, Social Security will distribute pain: Future retirees will have to accept so much reduction in the benefits they've been promised by the government. And that's what will make restructuring such a hard sell. Says Vice-President Michael Franc of the Heritage Foundation, “For this to succeed, Republicans will have to have the message running on all cylinders.”

But with expanded majorities in both the House and Senate, Bush has plenty of horsepower and vows to use it. Besides, the President can count on a massive lobbying campaign by corporate America to help convince the public of the benefits of personal accounts. Bush has made Social Security his No. 1 domestic issue, and defeat would be a major blow to his second-term agenda. And as friends and enemies alike have learned over the past four years, when George W. Bush wants something, he usually gets it.

Bush has so far refused to embrace any specific proposal, but he has given good reviews to a plan recommended by a commission he appointed in 2001. That proposal, known as the “Plan 2,” would allow workers to divert about a third of their payroll taxes—four percentage points of the 12.4% tax that workers and employers pay—into personal investment accounts, with a limit of \$1,000 a year. The money could be invested in a variety of funds, though the choices are likely to be more limited than many 401(k) plans, at least at first.

**OWNERSHIP
CRUSADE** Bush
seems willing to
spend serious
political capital

dividuals might get higher returns from those investments they are effectively receiving from the government-run m. But that change would not close the multi-trillion-dollar gap between what Washington has promised future retirees and what it has set aside to pay them. So the commission would change the way a retiree's first-year benefits are calculated. Today, they are tied to increases in average wages during a retiree's working life. In the new system, they would be tied to price inflation. Because prices grow more slowly than wages, this seemingly technical and innocuous shift would reduce promised benefits by close to 40% by 2075.

NO PAIN, NO REFORM?

NOW, THE PUBLIC SEEMS only dimly aware that restructuring Social Security, with or without private accounts, is likely to include deep benefit cuts. That's because Bush has focused his initial public-relations campaign on the urgent need to stabilize the system, plus the advantages of personal accounts. Bush has carefully said he would protect benefits for those near or close to retirement, and he insists participation would be voluntary (page 77). But neither he nor his critics have said much about what will happen to the Social Security checks of those far from retirement. "Sooner or later, we are all going to have to confront that," says one Senate backer of accounts. "But no one is in a hurry." And while few pols will say so publicly, the fate of Social Security benefits is what the Social Security battle is all about. "You can't do reform without some pain," says Senator Lindsey

Graham (R-S.C.). "We've got to get somewhere between the promises the government has made and the cold, hard facts of tax increases and benefit cuts."

For many pols, the accounts are legislative eye candy—a way to distract voters from the bite of benefit cuts or tax increases. "Accounts don't fix the solvency problem" says one senior Senate GOP aide. "We need them to sweeten the pot."

For now, the public remains focused on the accounts. And it is far from ready to embrace them. In a Dec. 16-19 survey by ABC News and *The Washington Post*, 53% of respondents said they would support allowing people to invest some of their Social Security taxes in the stock market, while 44% were opposed. But when asked if they would favor the accounts if the government had to borrow money to set them up, support fell to 46%. And when respondents were told their benefits might decrease if the stock market went down, only 37% said they would personally contribute. "The public is deeply split on personal accounts," says Carleton College political scientist Steven E. Schier.

Both sides are tailoring their messages to exploit those conflicted feelings. Treasury Secretary John W. Snow insists the accounts will allow people to "build real wealth for their retirement." By contrast, AARP's \$5 million campaign includes one ad—headlined "Winners and Losers"—that carries the dire tag line: "There are places in your retirement plan for risk, but Social Security isn't one of them."

To win over the public, Bush will deliver campaign-style speeches and hold town-hall meetings like the "conversation" he had on Jan. 11 in Washington with selected citizens from around the country. First, he is warning that there is a Social Security crisis just ahead, reassuring seniors that their benefits will not be affected, and promoting the benefits of personal accounts. Then he'll help Congress get rolling on a bill—though the White House hopes to avoid specifics for as long as possible.

In many ways, the push for private accounts will be a replay of the Presidential campaign. Conservative advocacy groups, think tanks, and right-wing radio and TV talk-show hosts are getting behind the White House. And big-gun business lobbies, such as the National Association of Manufacturers, are joining together to beat the drum for private accounts through coalitions such as the Alliance for Worker Retirement Security. At the same time, seniors groups, unions, liberal think-tankers, and lefty activist organizations such as MoveOn.org are mobilizing in opposition. Even some of the powerful 527 committees that were built to help elect John Kerry, such as America Coming Together, may jump into the fray. Combined, the combatants could spend more than \$50 million over the next year.

If Bush is going to make headway, though, he'll first have to bring together his own party. For now, the GOP is torn—not over the accounts but over how to pay for them and whether any funding fix should include tax increases or benefit cuts. "We look like we are shooting in a circle," says one frustrated business

It's no surprise that Dems are united against Bush's private accounts. But can Republicans agree on the details?

lobbyist. There are at least four informal GOP factions, and their memberships sometimes overlap: enthusiastic reformers, those desperate to avoid benefit cuts, those who oppose tax hikes, and those who worry that huge transition costs will add trillions of dollars to a federal debt that is already approaching \$5 trillion.

THE FREE-LUNCH BUNCH. The most gung ho reformers favor large accounts—funded with up to 6.2% of payroll—and oppose any tax hikes or benefit reductions to make the system solvent. Led by former House Speaker Newt Gingrich, former Vice-Presidential candidate Jack Kemp, Free Enterprise Fund President Stephen Moore, Senator John E. Sununu (R-N.H.), and Representative Paul Ryan (R-Wis.), they argue that the accounts will generate so much economic growth that total benefits will at least match what workers are promised today.

Sound familiar? It's perhaps the ultimate dream of supply-side growth driven by tax cuts. But it has a huge flaw. Today, payroll taxes are used to write checks to current retirees. If some of those taxes are diverted into private accounts, the money—up to \$2 trillion over 10 years—must be made up somehow. The free-lunchers would either borrow the funds or make major cuts in other government programs to finance the transition.

Bush has not committed to such a borrowing scheme. But Wall Street sources say that Bush aides are already feeling out financiers to gauge the market impact of borrowing an additional \$850 billion to \$1.5 trillion.

Piling on debt is hardly GOP dogma. But the free-lunchers have an important motive: Their strategy lets Republicans avoid

politically toxic payroll tax hikes or benefit cuts. The free-lunch crowd hopes that will help them win the votes of:

THE NO-BENEFIT-CUT CROWD.

Most members of this group are Republicans who have to face the voters in 2006. While a few, such as House Ways & Means Committee Chairman William Thomas (R-Calif.) seem willing to tackle Social Security, most would just as soon see the debate go away. Says Moore, whose Free Enterprise Fund lobbies for a market-based agenda: "House guys are absolutely terrified of voting for anything that smacks of a cut in benefits."

Many senators have the same problem. Take Olympia J. Snowe of Maine. In 2006 she will run for reelection in a swing state with a population that is heavily poor and old. Those voters don't want to hear talk about restructuring Social Security, let alone trimming benefits. And neither does Snowe.

It's no wonder. A Dec. 9-13 *NBC News/Wall Street Journal* survey looked at three ways to bolster the system—hiking payroll taxes, raising the retirement age, or cutting benefits. No more than one-quarter of respondents supported any of those ideas—and benefit cuts were the most noxious, with only 4% signing on. Fully 40% said none of the changes was acceptable.

READ THEIR LIPS. Raising payroll taxes is another way to finance private accounts and maintain basic benefits. But that runs afoul of many House Republicans for whom any tax hike is anathema. "This is like breaking a marriage vow for Republicans," says Franc of the conservative Heritage Foundation.

THE DEFICIT HAWKS. That leaves borrowing the money—which horrifies the fourth faction, a group that includes GOP budget watchdogs Susan M. Collins (Maine), Lincoln Chafee (R.I.), and Graham. Budget Committee Chairman Judd Gregg (N.H.) will oppose accounts funded only with government borrowing. "You can't just address this on one side of the ledger," Gregg says. "It has to be a comprehensive approach." The key player in this group is Graham, who would pay for accounts by raising the \$90,000 cap on wages subject to payroll taxes. No matter how much Republicans hate taxes, Graham says, big borrowing is a nonstarter. "If this debate is about deficits," says Graham, "the reform movement is going to lose."

Republicans aren't just split on policy; they can't agree on tactics, either. Many lawmakers insist that Bush come up with a specific plan, especially if he wants benefit cuts and tax hikes—steps they won't take without White House cover. But senators such as Finance Committee Chairman Chuck Grassley (R-Iowa), who are looking for bipartisan compromise, believe that any Bush plan would be poison to Dems.

Bush's margin for error is narrow. He cannot afford to lose many GOP lawmakers, especially in the Senate. "It will only take two or three of them to bring this entire enterprise crashing down," says one pro-reform Republican strategist. That cause Bush has almost no support from Democrats. Key Democrats signed on early to his tax cuts and Medicare initiative, many felt burned in their first-term dealings with Bush, and won't forget. It will be easy for lawmakers such as Representative Charles Rangel (D-N.Y.) to oppose Bush's accounts and rally their colleagues. But even moderates are deeply skeptical. "There is zero trust on the Democratic side," says Will Marshall, president of the centrist Progressive Policy Institute. "After Medbo, there is no confidence that Bush will bargain in good faith."

To make the White House's job even tougher, the Democratic leadership has made opposition to Bush-style private accounts a litmus test for party lawmakers. New Senate Minority Leader Harry Reid of Nevada has put Bush's accounts at the top of his hit list. "The level of opposition and the extent to which this is being made a defining issue is greater than I've ever seen," says Ed Lorenzen, executive director of Centrists, a Washington-based bipartisan think tank.

In part, that's because the issue strikes at the party's identity. Says Trinity College political scientist Diana Evans: "The Social Security issue is fundamental for Democrats. If they lose [the] Social Security [issue], what's left of the old New Deal coalition?"

Democrats overwhelmingly reject Bush's private accounts, but they can't agree on how to respond to any plan he does come out. Many say the party should mimic the GOP reaction to President Clinton's health-care-reform plan in 1993: just say

Players Watch in the Coming Debate

Besides selling American debt, President Bush has to keep supporters on board, mollify the middle, and fend off an array of foes.

"If this debate is about deficits, the reform movement is going to lose."

—Republican Senator Lindsey Graham

RTERS



House Ways & Means Committee Chairman William Thomas (R-Calif.) He'll be key to pushing any proposal through a skittish House.



Senate Finance Committee Chairman Chuck Grassley (R-Iowa) He will try to broker a bipartisan compromise that can pass the Senate.



Free Enterprise Fund President Stephen Moore He'll lead the fight for accounts but opposes using payroll tax increases to pay for the changes.

OPPONENTS



Representative Charles Rangel (D-N.Y.) He will try to rally House Democrats to stand against privatization in any form.



Senate Minority Leader Harry Reid (D-Nev.) He has put opposition to accounts at the top of his agenda. Can he keep Democrats in line?

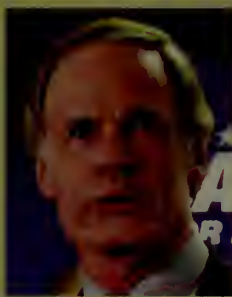


AARP CEO William Novelli The seniors' lobby backed Bush on Medicare reform but will fight him on private accounts.

IN THE MIDDLE



Senator Lindsey Graham (R-S.C.) Insists support for reform must be bipartisan; is willing to accept payroll tax hikes to fund accounts.



Senator Tom Carper (D-Del.) A moderate, he might work with Republicans on a centrist plan. But he'll likely reject major benefit cuts.



Senator Olympia Snowe (R-Maine) The GOP deficit hawk worries that accounts could bust the budget. May reluctantly support a compromise package.

However, a handful of moderates insist that Democrats should not simply oppose the Bush plan. This group of perhaps a dozen senators is quietly talking to Grassley and Graham for a deal. "I don't know that we as Democrats should have a jerk opposition to the establishment of private accounts," says Senator Tom Carper (D-Del.). "Democrats and Republicans have a responsibility to work together."

"FUNNY MONEY"

THEY HAVE SET TOUGH LIMITS on how far they will go. The House is unwilling to support massive borrowing or sharp cuts in benefits. Another Democrat who has expressed interest in compromise, Senator Kent Conrad (D-N.D.), says he won't back the plan based on heavy government borrowing. "I'm very open to a serious consideration of ways to address the long-term challenges of Social Security and creating new incentives for savings," he says. "But I'm not going to be part of some fun-money financing."

Some of the most extreme proposals being floated by the White House, such as the shift to price indexing, are most likely political stagecraft that will enable Bush to claim compromise once he moves to a more centrist position. At the same time, the White House has been carefully using Graham to test the waters for possible payroll tax hikes. While the South Carolina senator has been taking intense heat from the Right, Bush has not foreclosed the possibility of raising the payroll tax cap. If Bush is willing to deal, he'll have a chance to fix Social Se-

curity, say both Democratic and Republican insiders. But he'll need to build bridges with Democrats and sell economic conservatives on compromise. Many Democrats, for instance, say they might support modest benefit cuts if they are accompanied by an increase in taxable pay to, say, \$150,000. They also say they would back new incentives outside of the Social Security system that would encourage workers to save for retirement. Known as add-on accounts, these savings vehicles would effectively enhance existing 401(k) plans or individual retirement accounts without diverting payroll taxes. One major change: They'd create bigger incentives for low-income workers to save. Bush is already proposing his own new savings incentive called a Retirement Savings Account. With some tweaks to help lower-income workers, his proposal could become a model for add-on accounts.

Such a compromise would never satisfy small-government Republicans whose goal is to give Americans as much control over their retirement funds as possible while continuing to dismantle the New Deal. Nor would it mollify those Democrats whose real agenda is to hand the President a resounding defeat and who have little interest in giving up the Social Security issue for future elections. But if Bush were to cut a deal, he could seal an extraordinary legacy—though it would cost him an awfully big chunk of that political capital he likes to talk about. ■

—With Rich Miller in Washington

BusinessWeek online

For an interview with Treasury Secretary John W. Snow on Social Security reform, go to www.businessweek.com/extras

(LEFT TO RIGHT, TOP) ALEX WONG/NEWSMAKERS/GETTY IMAGES; CHRIS MADDALONI/ROLL CALL; (CENTER) DAVID SCULL/BLOOMBERG NEWS; (BOTTOM) DENNIS POROY/BLOOMBERG NEWS; JOANNE CHAN/REUTERS; WITH SON IAN/AT 12-AM/MTA



Windfall on Wall Street

AS WASHINGTON BEGINS to battle over letting workers invest a portion of their Social Security in private accounts, Wall Street's big guns are staying silent. Private accounts could pump vast sums into the markets—\$54 billion a year, by the Social Security Administration's estimate. Yet financial firms aren't endorsing the accounts, and their legions of lobbyists haven't descended on Congress. The reason: Financiers argue that running those accounts would be a low-margin, high-regulation business that's hardly worth the effort.

BY AMY BORRUS

But don't think for a minute that the Street is giving up on that gusher. Private accounts could be a boon for some firms—and their impact on stock trading will pump up the entire industry. Reform would further extend and entrench the equity culture that has taken root over the past 20 years.

Financial executives know that if their scandal-plagued firms lead the charge, they'll hand opponents of private accounts a killer issue. The AFL-CIO has already put 46 financial firms on notice that Big Labor will hammer them if they stump actively for the plan. "Social Security privatization is a risky scheme for America but a sure bet for the financial-services industry," argues AFL-CIO President John J. Sweeney.

So Wall Street is lying low. A few firms—notably brokers UBS Financial Services and Edward Jones—and industry trade groups are joining forces with business coalitions and conservative groups that will run grass-roots campaigns to marshal support for the plan. Financiers will lobby in earnest in Round 2—likely to start several years after the private accounts are established. By then, workers' deposits—which under many plans would be capped at \$1,000 a year—will start to add up. If law-

makers grow more comfortable with the accounts, they're willing to let workers branch out beyond simple index funds. Securities firms, banks, and money managers will agitate an ever-wider array of investment choices for account holders and as much leeway as possible on fees. The decisions in Round 2 on how private accounts ultimately are structured will determine the real winners and losers on Wall Street.

No question, there's big money to be made down the Street. The estimated \$54 billion that could pour into the market is roughly a quarter of stock and bond mutual funds' annual assets now. "In 30 or 40 years, the assets in these accounts will be the order of the entire present-day stock market of Japan," says Austan Goolsbee, a University of Chicago economics professor.

BEYOND FEES

WITH THE NEW MONEY will come a huge new crop of potential customers for Wall Street—the 50% of U.S. households that currently don't own stock. Most of the newbies will be young wage families who will never amass significant savings; others will be young workers who eventually will. That's a huge opportunity for mutual funds, though probably not for the service brokers that increasingly cater to the rich.

Financial firms scoff at suggestions that they stand to lose a killing on private accounts. A report by the Securities Industry Assn. argues that Wall Street firms could pocket at best \$1 billion in fees over 75 years from managing the accounts, a 8.5% increase in the financial sector's projected \$3.3 trillion total revenue over that time. "I don't see it being in any shape, or form a windfall for the industry," says James S. Glass, vice-chairman of T. Rowe Price Group Inc. and chairman of the Investment Company Institute, a fund industry group.

Why? Industry executives point out that, at least initially, Social Security accounts would be modeled on the retirement accounts for federal employees, which allows individuals to invest in a clutch of low-fee index funds managed by a handful of

could be a boon to such big index-fund managers as Bar-Global Investors, which has run the federal worker plan's funds since 1988, and State Street Global Advisors. As accounts grow, the Bush Administration tilts toward owners put their money, 401(k)-style, into actively managed funds. Under that scenario, fee income could balloon. Goolsbee says that if funds charged 0.8% of assets—close to the fee for big equity funds—Wall Street could rake in \$940 million in investment fees over 75 years. It would be “the largest total gain in American financial history,” says Goolsbee. Vanguard Group, Fidelity Investments, T. Rowe Price, and other big fund families that know how to manage small accounts while keeping costs down could be major players. But many will want in, and not just for the fee income: Managers will use the accounts as a base from which to sell other products and services, from capturing rollovers of individual retirement accounts to planning estates and trusts. “The cross-sell opportunities are the brass ring,” says Robert M. Hegarty, president for securities and investments research at Morgan Stanley Group, a financial-services research firm. Every sector of financial services will be looking for a piece of

the action. Banks will lobby hard to get certificates of deposit into the asset mix. Insurers will argue that retirees should be forced to convert their private accounts to annuities, which offer a guaranteed stream of monthly payments for life. “You don’t want lump-sum payments that people can blow right away,” says Frank Keating, president and CEO of the American Council of Life Insurers.

A key battle will be over investment fees. Wall Street will argue for as much leeway as possible, but a ceiling is probably inevitable. “To make the cut, you’ll have to accept a cap on what you charge,” predicts Kim Wallace, managing director and chief political strategist at Lehman Brothers Inc. Higher-priced firms worry about getting caught in a squeeze—demand for more services but pressure to keep costs low.

For now, Wall Streeters are focusing on the downside—and giving the reform cause a wide berth. But if private Social Security accounts become a part of American life, financiers won’t hesitate to elbow in for a share of the pie. The land rush of lobbyists will happen—just later. ■

—With Suzanne Woolley, Diane Brady, and Emily Thornton in New York

COMMENTARY BY PETER COY

Lesson from Abroad: Make Them Mandatory

President George W. Bush favors freedom of choice in Social Security. He argues that people who want to divert some of their payroll taxes into personal savings accounts should have that right, but others should be able to stick with the current system. Treasury Secretary John W. Snow, the No. 2 Social Security reform spokesman, says keeping personal accounts voluntary is crucial to winning public support: “Things that aren’t compulsory are rarely better accepted by people,” he told *BusinessWeek* on Jan. 10. At first blush it seems fair and reasonable that Americans opt in or out of personal accounts. But if the experience of other nations is any guide, personal accounts usually work better when they’re mandatory—as they are in Chile, Hungary, Mexico, Poland, and Sweden. When accounts are voluntary, low-income workers are less likely to participate—leaving them stranded in traditional social security systems that governments are desperately trying to shrink. Making accounts voluntary also raises costs for account holders and adds to confusion over whether such accounts are the right choice—discouraging saving at all.

Britain’s experience is the most relevant. Starting in 1988, British workers were given the option of directing part of their social security contributions into personal accounts. Over the years, higher-income Brits have embraced personal accounts and have largely benefited from them. But low-income workers, who are at the greatest risk of an impoverished retirement, have generally shied away from the accounts, often out of fear or confusion. That’s similar to America’s experience with 401(k) retirement plans, where, despite such inducements as matching contributions from employers, low-income workers are the least likely to sign up.

Why is that a bad thing? Because in Britain as in the U.S., the hope for personal accounts is that workers will earn a good return, allowing the government to save money by trimming the basic social security benefit. But as Britain’s blue-ribbon Pensions Commission observed last year, low-income workers don’t choose personal accounts as much. So they’re relying on a system that is

in financial straits and politically vulnerable as the rich bail out. A Hobson’s choice? Sure. That’s why if there are going to be personal accounts, everyone should have one.

Compounding the inequity is the confusion and cost generated by making personal accounts voluntary. British workers have been whipsawed by contradictory advice over whether or not to establish

personal accounts. Financial firms paid roughly \$15 billion to investors to settle charges of “mis-selling,” according to a Boston College estimate. To avoid such charges, British firms counsel potential customers—in many cases for an hour or more—about whether the accounts are right for them. That expensive service is one reason British fund managers charge a fee of 1% a year. Over time, such fees absorb 20% or more of an individual’s pension saving, according to Britain’s

Pensions Commission.

You can debate endlessly whether personal accounts are a good idea in the first place. The international experience—starting with Chile in 1981—is that the accounts increase workers’ sense of ownership but don’t magically fix unhealthy social security systems. If a country does opt for them, mandatory seems the cleanest, simplest way to go. As the U.S. tussles over the future of Social Security, it might take a lesson from the rest of the world—and let experience trump politics.



BRITAIN Voluntary accounts often leave low earners worse off

The Gnat Nipping At Microsoft

Mozilla may be a tiny nonprofit, but its Firefox browser is grabbing market share

HOW'S THIS FOR A MISMATCH? On one side, you have Microsoft Corp., the largest software company in the world, with \$37 billion in revenues and 57,000 employees. On the other, there's the Mozilla Foundation, a not-for-profit organization with a \$2 million budget and just 16 employees wedged into a single room in an office park in Mountain View, Calif. It's Godzilla vs. Mozilla, and Mozilla is a midget.

Yet the Mozilla Foundation is pulling off a feat that would have seemed preposterous a year ago: It's taking share from Microsoft in the market for Internet browsing. According to a survey released on Jan. 12 by Web site analytics firm WebSideStory Inc., Mozilla's free Firefox browser has grabbed a 4.6% share over the past six months and seems well on the way to its stated goal of 10%. Meanwhile, Microsoft's Internet Explorer has slipped 4.9 percentage points, to 90.6%, the lowest in three years. "It's an emotional number. When Microsoft drops to 90%, it's big news," says Jeffrey W. Lunsford, chairman of WebSideStory.

Microsoft is hardly on the run. It has an overwhelming lead, and most corporations have adopted Internet Explorer for their employees—so it should have



staying power. But many of the 16 million consumers who have switched to Firefox see the upstart program as safer from viruses and packed with innovations. Those include a feature called "tabbed browsing" that makes it easier to move quickly from one Web site to another, in

part, by firing up a series of favorites all at once. But Microsoft has been working hard to clamp down on security flaws and vows to make other improvements. "These features, along with Microsoft's world-class customer support, could make IE a compelling choice," says a Microsoft spokesman.

Still, analysts say Firefox could have an outsized impact on the future of the Web. If Mozilla and the other Microsoft browser outfits hold their own or gain share, the 15% of Web sites that aren't completely compatible with Microsoft browsers will come under pressure to design their sites to open up to standards. That way, Microsoft will be able to control how content is presented

on the Web. It could also create opportunities for competitors to sell rival Net software since Microsoft won't be able to take advantage of the link between IE and Microsoft products. "We're not out of Microsoft," says Mozilla Foundation President Mitchell Baker. The group's goal is to offer people a better experience. "The Web remains open to people actually choose."

The Mozilla Foundation isn't stopping there. It has been hard at work on a variety of software projects in recent months. A new program called "derby" was released in mid-December and

has since been downloaded by more than 1 million consumers. The group has a handful of other programs on the drawing board, including an electronic calendar called Sunbird and a small browser for use in cell phones and personal digital assistants, code-named M

Mozilla's Bag of Tricks

The nonprofit is delivering several free programs on the heels of its popular Firefox browser.

THUNDERBIRD

The e-mail program, released last month, offers security, spam filters, built-in search, and a customizable user interface

ITS SUCCESS 2 million downloads so far

SUNBIRD

It's a calendar program that lets Firefox and Thunderbird users share their calendars with others, via certain Web sites

RELEASE GOAL 2005 or 2006

MINI MOZILLA

Minimo is a stripped-down version of Firefox, designed for use as a browser on high-end cell phones and PDAs

RELEASE GOAL 2005 or 2006

are expected to be released in 2006. Mozilla's provenance is as improbable as its burst of success. It was born to the Web pioneer Netscape Communications Corp. in 1998 to harness the power of the open-source software movement. The idea was that volunteer programmers from around the world would help make improvements to the company's browser. After America Online bought Netscape in 1999, the project lost steam. But it was reborn a year and a half ago as an independent organization funded by AOL, Sun Microsystems, and Nokia. Independence seems to have been a key. Development raced ahead for Firefox, a new browser design. It's free, and Mozilla asks users to make tax-deductible donations to support development efforts.

Without a remarkable guerrilla marketing campaign, Firefox adoption might not have leapt ahead so rapidly. The campaign, called SpreadFirefox, is led by a handful of Mozilla volunteers and carried out by 58,000 volunteers. The campaign has tapped into the power of blogs, or blogs, to generate buzz. It not only set up its own blog (spreadfirefox.com) to coordinate activities but also hooks up with others to expand its reach. If a blogger says something about Firefox, for example, it is rewarded with links to its site. The guerrilla campaign "is fanning the flames," says analyst Stacey Quandt of research firm Robert Frances Group Inc.

One of this has been a pinch-yourself experience for Mozilla's Baker. A former reporter, she became accustomed to living in obscurity in the Mozilla project's early days. Now she's struggling with the group's recognition. She gets mobbed by parents at her son's school and approached by strangers at her class. Recently, after Baker wore a Mozilla T-shirt to a friend at the Arts, the circus-skills gym where she works out, a nearby woman shouted: "Are you from Mozilla? Firefox changed my life!" She then knelt and bowed before a stunned Baker.

These may be heady times for the Mozilla crew, but they know not to take sudden success for granted. They remember how Netscape was crushed by Microsoft juggernaut. This game is different, though. Mozilla has the vast, vibrant open-source movement on its side. This time, Godzilla may not repeat the way it has in the past. ■

—By Steve Hamm in New York



ZHOU "When we make an investment, we think: 'What do real people need?'"

Mining the Middle Kingdom

Rivals laughed when IDG set up a VC fund in China. Now they're rushing in

WHEN PATRICK J. McGovern, chairman of the Boston magazine conglomerate International Data Group Inc., was thinking about starting a venture capital fund for China in the early 1990s, he figured it might be easier to scale the Great Wall with his bare hands. The Communist government dominated the economy. Seasoned entrepreneurs were almost nonexistent. Most challenging, with no national stock market and few private

companies, it would be tough for IDG to cash out of the startups it backed. Still, lured by the potential of a rapidly evolving, billion-person market, he plowed ahead, creating the first venture fund in China in 1992. Rival venture firms thought he had lost his marbles. "They all laughed at us," says McGovern.

Now McGovern and his posse of plucky Chinese partners are getting the last laugh. The company's China venture arm, IDG Technology Venture Investment Inc., has been raking in the dough since the China market began to soar five years ago. It has earned a 42% internal

rate of return on the \$170 million it has put into China since its founding. Even better, its early entry and active support of Chinese entrepreneurs has given it an enviable reputation as the place to go to get financing for a tech startup. As a result, IDG has first crack at many deals in what is becoming one of the world's hottest markets. "For early-stage investment, IDG gets the best deals," says Gavin Ni, chief executive of Zero2ipo Ltd., a Beijing firm that tracks Chinese venture capital.

COUNTRY WISDOM

IDG TECHNOLOGY'S approach is a blend of East and West. Its investments, which average just over \$1 million, are typically in startups that are trying to adapt successful U.S. business ideas to the China market. It has helped create Chinese versions of Amazon.com, eBay, and Bloomberg, among others. Its 10 general partners, all Chinese, usually modify the business model for their own market. For example, Ctrip.com International Ltd., an online travel agency based in Shanghai, is similar to travel site Expedia Inc., but it stresses phone support much more than its U.S. counterpart. The reason is that many Chinese prefer to search for flights online and then purchase tickets by phone. "They feel like the transaction is [more] secure" on the phone, says Quan Zhou, the fund's managing director. Such insights helped IDG turn its \$1.6 million investment in Ctrip into \$37 million.

Zhou's knowledge of the local market isn't something outsiders will pick up quickly. The 47-year-old grew up in Anshan, an industrial city he compares to Pittsburgh. During the Cultural Revolution, when he was 17, he was sent to work

on a farm for three years, earning a penny a day. He later went to the U.S., earning a PhD in fiber optics at Rutgers University, and then he became a consultant on research at NASA. Yet Zhou says it's his farm experience that has proved critical in guiding his venture decisions. "When we make an investment, we think: 'What do the real people need?'" says Zhou.

That Cultural Revolution investing philosophy will be applied even more actively in the years ahead. *BusinessWeek* has learned that IDG Technology is opening its biggest fund yet, at \$150 million, in February. Zhou says the new fund will focus on digital media, consumer Net services, and software for corporations.

Success, however, may be harder to come by in the future. Many venture capitalists, in the U.S. and elsewhere, have come around to IDG's perspective that China is the next great frontier. Indeed, 2004 was a record year for venture investing in China, with 253 deals and \$1.3 billion invested, according to researcher Zero2ipo. And a host of rivals are getting more aggressive in the market, including Japan's Softbank, America's Accel Partners, regional players such as Taiwan's Acer Technology Ventures, and local Chinese firms.

IDG Technology faces not just competition but also controversy. There's a potential conflict of interest between its publishing and investing arms. While its tech publications in the U.S. and China often cover the Chinese companies that have received IDG venture money, they fre-

quently don't disclose the financial interest. Orville Schell, dean of the Graduate School of Journalism at the University of California at Berkeley and a China expert, says these kinds of conflicts are far more common in China than in the U.S. "In the U.S., such ownership should be disclosed because of the possibility that IDG's recommendations may be overly supportive of its backed startups."

The president of IDG's publishing business in China, Hugo Shong, says his company suggests that editors disclose their investments when they write features on IDG-financed companies, but it doesn't insist on it. He also says that IDG's publications are run as independent operations, and that favorable coverage is given to IDG-financed companies.

The story of IDG Technology's success in China really begins with IDG's early investments. After Deng Xiaoping unveiled the "open door" policy in December 1978,

McGovern flew to China and negotiated the first venture between a U.S. company and the Chinese government. Although skeptics thought it would take years to get up and running, IDG was publishing a weekly paper within six months. By 1992, it was turning a profit in the country. That year, IDG set up its first venture fund with \$70 million and took a large stake in the market pretty much to itself. "We would line up and ask for money from McGovern. 'We didn't have to negotiate with four or five other VCs.'"

Today, venture capitalists can't get into each other on flights to China. IDG Technology has a crucial advantage: *guanxi*, or relationships. While most investors fly in from Hong Kong or try to prospect for deals, IDG maintains a person staff spread across four offices. It has a reputation for helping entrepreneurs succeed. Jian Lu, founder of Moloon International Inc., which makes games and other entertainment software, says he got offers from venture firms to finance his company. IDG's was the lowest, but he chose it with the firm anyway. "IDG has the strongest partner team," says Lu. In 2004, McGovern's long-ago bet on the China market looks anything but crazy.

—By Spencer E. Ante in New York with Dexter Roberts in Beijing

The downside: Conflicts of interest are plentiful

Scaling the Great Wall

IDG Technology Venture Investment has established itself as the most active and successful venture firm operating in China.

LEADERSHIP The 30-person team is led by Quan Zhou, a Chinese native who earned a PhD in fiber optics from Rutgers University. He says his three years as a farmer during the Cultural Revolution helped him understand the needs of "real people."

STRATEGY IDG focuses on early-stage deals. It frequently adapts U.S. successes to China, such as a Chinese version of e-tailer Amazon.com. The result? Returns of 42%.

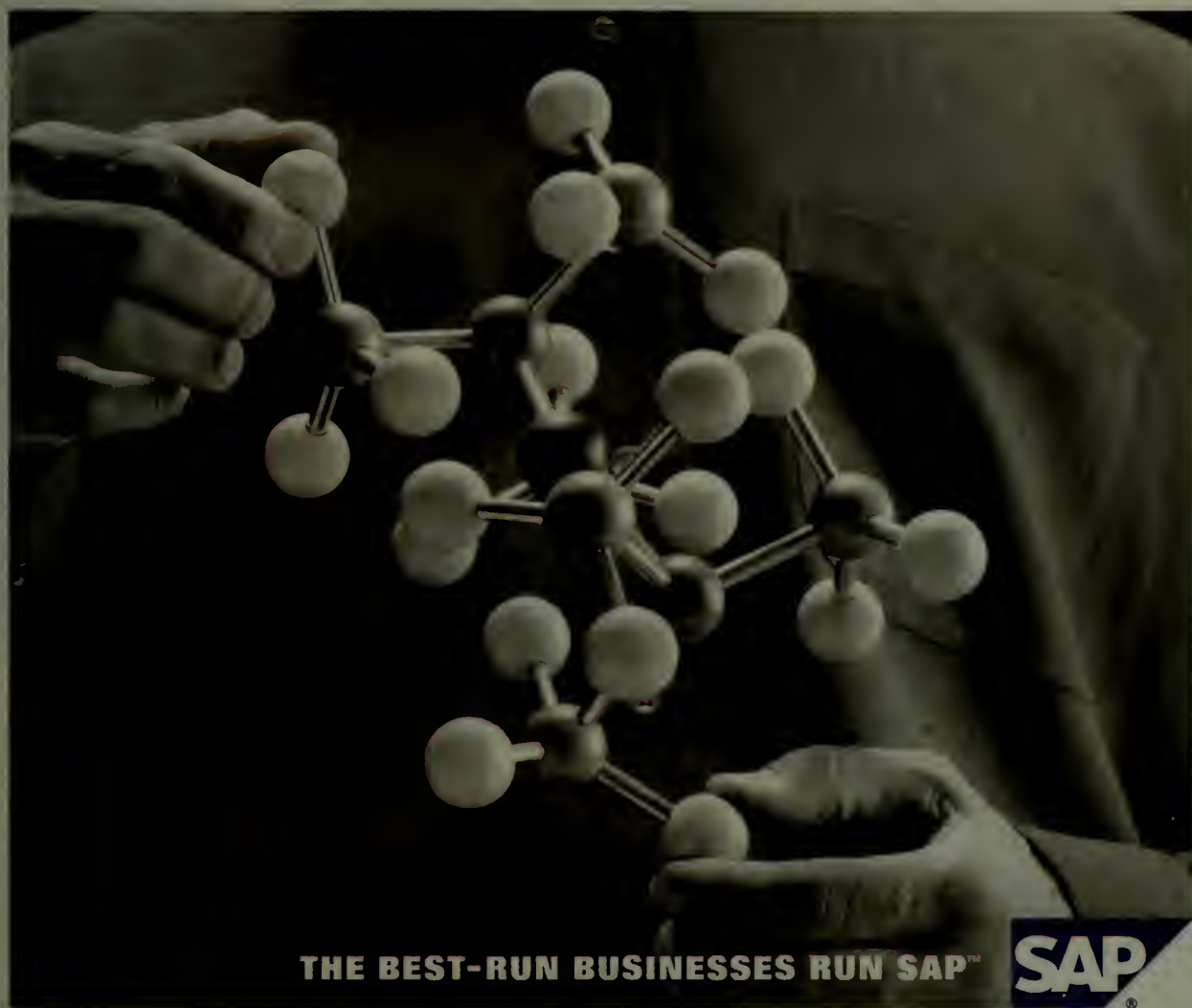
GREATEST HITS Online travel planner Ctrip.com and finance site China Finance Online. With the Ctrip deal, IDG invested \$1.6 million and got back \$37 million.

NEXT HITS IDG hopes to take three of its companies public in 2005: Real estate portal SouFun.com, online ad provider Allyes, and wireless media company Mtone Wireless.

SECRET TO SUCCESS Top entrepreneurs go to them. IDG has established a rep for management expertise and government ties that startups need to succeed in China.

BusinessWeek online For an interview with IDG Chairman Pat McGovern, go to www.businessweek.com/extras

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Personal Business Mutual Funds



Spotting The Very Brightest Stars

ratings help you find your way through a crowded mutual-fund universe. **BY LEWIS BRAHAM**

RANK JAMES CALLS HIMSELF “the best money manager in Alpha, Ohio—population 400.” With \$800 million in assets, mostly in private accounts, his company, James Investment Research, is small by investment industry standards, and he runs it from an isolated office on 35 wooded acres of countryside. “We’re terrible at marketing here,” he says. “We’re not good at anything but research.” Yet as a result of that research, one of James’s three mutual funds—the tiny \$15.1 million James Small Cap

—ranks in the top tier in *BusinessWeek* Mutual Fund Scoreboard, having outperformed the average stock fund’s return over the past five years with far less downside risk. James’s largest fund, the \$92.1 million James Golden Rainbow Fund, which blends stocks and bonds, is a top performer as well, just missing the top spot.

Moreover, James has been more conservative with risk control than with making bets. “Investors who have done well in the long run were those who

focused on preserving capital in bad markets,” he says.

BusinessWeek has been publishing the Mutual Fund Scoreboard for 20 years now, and it often unearths gems such as the James funds. The scoreboard’s ratings are calculated by an objective, quantitative system wherein big marketing budgets or a portfolio manager’s popularity don’t count at all.

Of course, there’s more here than the ratings. You can get all the basics, such as 1-, 3-, 5-, and, if available, 10-year returns;

sales charges; and expense ratios. We also publish aftertax returns, a much harder-to-find number. Our calculations are based on each year’s highest federal tax rates for dividends and capital gains. You get a truckload of portfolio data, too, including a fund’s risk level, turnover, cash levels, and largest holdings.

HOMING IN ON GEMS

THE HEART OF THE scoreboard, though, is the ratings. To get one, a fund must be at least five years old. That’s because in computing the grades, we first compare each fund’s monthly performance with three-month U.S. Treasury bills in each of the past 60 months. When a fund fails to beat the T-bill’s “risk-free” return, it gets negative marks, which are then subtracted from its nominal total return. Next we rerank all of the equity funds on these risk-adjusted results. Of 2,612 equity funds with five-year track records, only 195 earned an “A” this year. Tables of all of our A-rated stock funds start on page 88, but you can find an interactive version of the entire scoreboard at bwnt.businessweek.com/mutual_fund/. Next week we’ll look at bond funds.

We also rate funds against others in specific categories, such as large-cap growth, foreign, or real estate funds. Only 180 made an A category grade in the latest scoreboard. A category rating serves two purposes. It’s a good way to identify the best funds in out-of-favor sectors—funds that wouldn’t do well in the overall ratings. And it indicates the best plays in a sector so strong that all the funds seem to be shining. For instance, 63 small-cap value funds now receive A grades for overall performance, in part because over the past five years small-cap stocks have soundly beaten large-cap, and value stocks trounced growth. But look at the category rating, and you’ll find that only 9 of those 63 got As, and only three are open to new investors—American Advantage Small Cap Value, Pacific Capital Small Cap, and CGM Focus. All told, only 53 funds got A ratings for both their category and overall performance.

Real estate has been even hotter than small-caps in recent years, with 49 such funds receiving overall A ratings. That’s up from just 18 a year ago. Drill down into the category grades of such funds, and you’ll find not nearly as many

BusinessWeek online For interviews with fund managers, see www.businessweek.com/magazine/extra.htm, and for complete results of more than 5200 funds, go to http://bwnt.businessweek.com/mutual_fund/

Personal Business Mutual Funds

are appealing. Only three—Alpine Realty Income & Growth, Alpine U.S. Real Estate Equity, and CGM Realty—receive double-A ratings.

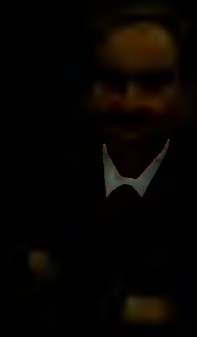
Alpine Funds President Sam Lieber would be the first to warn that you may be buying near a peak. Real estate investment trusts (REITs), publicly traded companies that buy real estate, are on average “trading at a 15% to 20% premium to the values of their underlying properties, which are richly priced as well,” he says.

Since Lieber must invest in real estate, he pays close attention to risk control. Alpine Realty Income & Growth invests heavily in REIT preferred stocks, which are higher-yielding and less volatile than REIT common shares. Lieber is also not afraid to take profits and increase cash positions as valuations rise. Our scoreboard lists his cash positions. In general it's a good indicator of how enthusiastic a manager is about his investment sector: the more cash, the less excitement. Bear in mind that the portfolio data reflect the most recently published fund reports, and cash levels can change quickly.

That said, the scoreboard's portfolio data can give you a lot of insight into a fund. For instance, Hibernia Mid Cap Equity has low turnover. That sets it apart from most mid-cap growth funds, which tend to have rapid-fire trading practices. Martin Sirera, the fund's manager, believes his buy-and-hold philosophy contributes to the fund's success. “A low turnover adds to performance over the long run because it keeps transaction and market-impact costs down,” he says. Of the nine mid-cap growth funds that earned A category ratings, eight have low

We're terrible at marketing here. We're not good at anything but research”

—Frank James
James Investment Research
Alpha, Ohio



or very low rates of share turnover.

Another telling scoreboard statistic is the percentage of the fund made up by the 10 largest stocks. For the ABN AMRO Mid Cap Fund, for instance, the figure is 39%. Since the average fund has about 22.4% in its top 10, this ABN AMRO mid-cap fund is fairly concentrated. The higher this number, the more dependent the fund is on the performance of individual stocks rather than broader market trends. Concentration can be risky, but this

fund's risk rating is average. The cause manager Thyra Zerhusen made downside risk by making it her business to know the companies she owned “in depth” and invests only in those with clean balance sheets and defensible product lines such as Readers Digest and Engelhard Corp., a specialty chemical maker. “I wouldn't buy a retail Gap, which could do great this year but badly in the next because fashion changed,” she says.

The Big Funds

Here's how *BusinessWeek* rates the heavyweights—the largest equity funds by assets.

FUND	ASSETS BILLIONS	OVERALL RATING	AVG. ANN'L TOT. RETURN*	CATEGORY	CATEGORY RATING
Vanguard 500 Index Inv.	\$81.8	C-	-2.4%	Large-cap Blend	C
Investment Company of America A	63.6	C	3.3	Large-cap Value	C-
Fidelity Magellan	62.6	C-	-3.9	Large-cap Blend	C-
Washington Mutual Investors A	61.4	B	5.4	Large-cap Value	C
Growth Fund of America A	58.2	C	1.8	Large-cap Growth	A
Standard & Poor's Depository Rcpts.	52.1	C-	-2.4	Large-cap Blend	C
Fidelity Contrafund	42.9	C	1.6	Large-cap Growth	A
Dodge & Cox Stock	41.4	B+	12.4	Large-cap Value	A
Income Fund of America A	40.7	B+	9.4	Domestic Hybrid	A
EuroPacific Growth A	35.7	C	-0.2	Foreign	C

*2003 annualized total return, including dividends and capital gains before taxes

Data: Standard & Poor's

GOOD FUNDS, BAD SECTORS

ANOTHER IMPORTANT scoreboard statistic is a fund's worst quarter in the past five years. Consider it a stress test, or a way for you to visualize a fund's potential in the depths of a bear market. Look at the A-rated Berwyn Income Fund, for instance. You'll see that the 2.4% loss in the second quarter of 2004 is small relative to most other funds on the A list. Its 7.3% loss in the third quarter of 2003 is equally small. In contrast the Lou Holland Growth Fund is more volatile, with a 15.8% loss during its worst quarter in 2002. But it has also had a higher high, gaining 15.7% during its best quarter in 2001. For a fund that has long-suffered large-cap growth can't it has managed to navigate the past few years well enough for an A category

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Personal Business Mutual Funds



"When I trim a position in a stock, I try to keep an eye on which shares I'm selling to minimize the tax cost"

—Thyra Z.
AB.
Mid-Cap

ing, though it has a C overall. Buying good funds in unpopular categories can be a smart investment strategy.

Technology funds have suffered the most of any category in recent years, so any of those funds that pops up on the A list is of interest. Only four score an A category rating: Fidelity Select Software & Computer Services Portfolio, Icon Information Technology, North Track PSE

experience as a technology fund manager. "Our strategy is a little different," says co-manager Robert Dean. "Instead of being a pure tech fund, it's an innovation-type fund, heavily weighted in technology but also health care and other industries." That diversification, plus Johnson and Dean's decision to move heavily into cash when the downturn started, helped cushion the blow of the bear market. The fund

Tech 100 Index, and Franklin DynaTech. None has an overall rating better than C. Franklin DynaTech is new to the list, though its lead manager, Rupert Johnson Jr., has 36 years of ex-

perience as a technology fund manager. "Our strategy is a little different," says co-

manager Robert Dean. "Instead of being a pure tech fund, it's an innovation-type fund, heavily weighted in technology but also health care and other industries." That diversification, plus Johnson and Dean's decision to move heavily into cash when the downturn started, helped cushion the blow of the bear market. The fund

has still managed to deliver solid, not stellar, returns during the bull market. In general it is better to invest in equity funds that are broadly diversified than light there's hardly a more diversified fund than Oakmark Global. "I have the best job in the world because my investment mandate is so broad," says Robert Welsh, the fund's manager. "I'm not limited by geography or market cap. Welsh takes full advantage of his flexibility. After years of investing in tiny small-cap foreign stocks he has the freedom to move into blue chips, food giant Nestlé and drugmaker SmithKline, which he says offer more attractive valuations. Of course, such flexibility also means that a manager has more chances to screw up by picking the wrong country or stock group. It's one more reason to own an A-rated fund.

The Fund Categories

The first half of the decade was difficult, but equity mutual funds still beat the Standard & Poor's 500-stock index.

CATEGORY	AVERAGE ANNUAL TOTAL RETURN*				CATEGORY	AVERAGE ANNUAL TOTAL RETURN*			
	2004	2002-2004	2000-2004	1995-2004		2004	2002-2004	2000-2004	1995-2004
Real Estate	32.3%	24.0%	21.7%	15.4%	Domestic Hybrid	7.9%	5.1%	2.9%	
Precious Metals	-6.5	33.9	18.6	3.9	Utilities	23.3	5.0	1.6	
Small-cap Value	19.8	15.3	16.3	14.8	Small-cap Growth	11.1	4.7	0.8	
Natural Resources	30.3	17.5	15.3	13.7	World	14.7	7.7	0.0	
Financial	14.0	11.6	13.0	17.0	Foreign	18.8	12.0	-0.3	
Mid-cap Value	18.2	12.1	12.1	13.8	Large-cap Blend	9.6	2.9	-1.6	
Small-cap Blend	18.0	11.7	9.4	13.6	Diversified Pacific/Asia	15.3	14.0	-3.0	
Health	9.9	1.2	8.2	14.5	Mid-cap Growth	12.6	4.0	-3.7	
Latin America	39.4	21.6	8.0	7.5	Large-cap Growth	7.6	0.3	-6.6	
Mid-cap Blend	15.8	9.4	7.6	13.9	Japan	13.0	11.9	-8.6	
Miscellaneous	11.1	7.6	6.3	11.6	Communications	22.7	-0.1	-10.6	
International Hybrid	13.2	10.7	5.5	10.4	Technology	3.7	-1.8	-16.3	
Diversified Emerging Mkts.	23.4	22.5	5.5	4.8	All Equity	13.0	7.3	3.0	
Large-cap Value	12.6	5.4	4.3	11.6	U.S. Diversified Equity	12.1	5.4	2.4	
Europe	24.2	16.1	3.9	10.3	International Equity	18.6	13.2	1.1	
All Cap	12.3	6.4	3.7	13.8	S&P 500	10.9	3.6	-2.3	
Pacific/Asia ex-Japan	14.8	16.8	3.2	4.2					

*Appreciation, reinvestment of dividends and capital gains before taxes

Data: Standard

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Equity Fund Scoreboard

How to Use the Tables

BUSINESSWEEK RATINGS Overall ratings are based on five-year, risk-adjusted returns. They are calculated by subtracting a fund's risk-loss factor (see RISK) from pretax total return. Category ratings are based on risk-adjusted returns of the funds in that category. The ratings:

- A SUPERIOR** **C- BELOW AVERAGE**
B+ VERY GOOD **D POOR**
B ABOVE AVERAGE **F VERY POOR**
C AVERAGE

These tables list A-rated funds. For others go to http://bwnt.businessweek.com/mutual_fund

MANAGEMENT CHANGES **1** indicates the fund's manager has held the job at least 10 years; **2** indicates a change since Dec. 31, 2003.

S&P 500 COMPARISON The pretax total returns for the Standard & Poor's 500-stock index are as follows: 2004, 10.9%; three-year average (2002-2004), 3.6%; five-year average (2000-2004), -2.3%; 10-year average (1995-2004), 12.1%.

CATEGORY U.S. diversified funds are classified by market capitalization of the stocks in the

portfolio and by the nature of those stocks. Average market cap is greater than \$10 billion, the fund is large-cap; from \$2 billion to \$10 billion, mid-cap; less than \$2 billion, small-cap. All-cap funds are those that don't follow capitalization policy. Value funds are those whose stocks have price-to-earnings and price-to-book ratios lower than average for the market capitalizations. Growth funds have price-to-earnings ratios higher than average p-e and p-b ratios. Bond funds are those in which the ratios are at or below average. Hybrids mix stocks and bonds.

FUND/SYMBOL	OVERALL RATING	CATEGORY	RATING	SIZE	FEES	2004 RET		
(COMPARES RISK-ADJUSTED PERFORMANCE OF EACH FUND AGAINST ALL FUNDS)		(COMPARES RISK-ADJUSTED PERFORMANCE OF FUND WITHIN CATEGORY)		ASSETS \$MIL.	% CHG. 2003-2004	SALES CHARGE (%)	EXPENSE RATIO (%)	PRE-TAX
ABN AMRO MID CAP N CHTTX	B+	Mid-cap Blend	A	423.9	130	No load	1.34 †	18.9
ABN AMRO REAL ESTATE N ARFCX	A	Real Estate	C	76.6	51	0.00 *	1.37 †	33.4
AFBA FIVE STAR LARGE CAP INSTITUTIONAL AFBEX	C	Large-cap Growth	A	20.3	-1	No load	1.08	7.8
AFBA FIVE STAR USA GLOBAL INSTITUTIONAL AFGLX	C	Large-cap Growth	A	40.0	1	No load	1.08	6.6
AIM ENERGY INV. FSTEX (a) 1	A	Natural Resources	B	311.1	52	No load ‡	1.76 †	36.6
AIM GOLD & PRECIOUS METALS INV. FGLDX (b) 1	A	Precious Metals	C	117.8	-18	No load ‡	1.93 †	-4.9
AIM REAL ESTATE A IARAX	A	Real Estate	B+	625.3	147	4.75	1.65 †	36.0
AEGIS VALUE AVALX	A	Small-cap Value	B+	815.2	92	No load	1.50	13.5
AL FRANK VALUX	A	Mid-cap Value	B+	244.0	103	0.00 *	1.79 †	15.8
ALLIANCEBERNSTEIN REAL ESTATE INV. ADV. ARSYX	A	Real Estate	B	159.3	56	No load	1.44	35.2
ALLIANCEBERNSTEIN REAL ESTATE INV. INSTL I ARIIX	A	Real Estate	C	626.0	61	No load	1.08	35.6
ALPINE INTERNATIONAL REAL ESTATE EQUITY Y EGLRX 1	A	Real Estate	F	115.4	34	0.00 *	1.52	36.1
ALPINE REALTY INCOME & GROWTH Y AIGYX	A	Real Estate	A	445.4	124	No load	1.38	31.0
ALPINE U.S. REAL ESTATE EQUITY Y EUEYX 1	A	Real Estate	A	245.5	78	No load	1.67	39.4
AMSOUTH SELECT EQUITY A ASECX	B	Large-cap Blend	A	19.1	90	5.50 *	1.29	9.9
AMERICAN AADVANTAGE BALANCED PLANAHEAD AABPX 1	B+	Domestic Hybrid	A	25.9	98	No load	0.94	12.7
AMERICAN AADVANTAGE SM. CAP VALUE PLANAHEAD AVPAX	A	Small-cap Value	A	614.0	715	No load	1.16	23.2
AMERICAN CENTURY GLOBAL GOLD INV. BGEIX	A	Precious Metals	C	759.6	3	0.00 *	0.69	-8.2
AMERICAN CENTURY REAL ESTATE INV. REACX	A	Real Estate	B	491.2	92	No load	1.17	29.7
AMERICAN CENTURY SMALL CAP VALUE INV. ASVIX	A	Small-cap Value	B+	1267.8	36	No load ‡	1.26	21.8
AMERICAN CENTURY SMALL COMPANY INV. ASQIX	A	Small-cap Blend	A	943.3	145	No load ‡	0.89	28.3
AMERICAN CENTURY VALUE INV. TWVLX	B+	Large-cap Value	A	2322.1	21	No load	1.00	14.4
AMERICAN BALANCED A ABALX 1	B+	Domestic Hybrid	A	28004.1	51	5.75	0.67 †	8.9
AMERICAN EAGLE CAPITAL APPRECIATION AECAX	B	Large-cap Growth	A	3.5	-41	No load	3.85	6.9
AMERICAN EAGLE TWENTY AETWX	B	Large-cap Growth	A	2.4	-47	No load	4.40	18.5
ARIEL ARGFX 1	A	Small-cap Value	B	3950.0	74	No load	1.07 †	22.0
ARMADA SMALL CAP VALUE I AMRIX 1	A	Small-cap Value	B+	893.1	7	0.00 *	1.18 †	21.6
ARMSTRONG ASSOCIATES ARMSX 1	C	Large-cap Growth	A	16.7	11	No load	1.20	8.0
ARTISAN MID CAP ARTMX	B	Mid-cap Growth	A	5545.6	36	No load ‡	1.19	14.7
ARTISAN SMALL CAP VALUE ARTVX	A	Small-cap Value	B	1350.5	53	No load ‡	1.18	21.2
AUXIER FOCUS AUXFX	B+	Large-cap Value	A	75.8	132	0.00 *	1.35	10.7
AVONDALE HESTER TOTAL RETURN AHTRX	B	Large-cap Growth	A	12.4	33	No load	1.91	16.3
BERWYN BERWX 1	A	Small-cap Value	B	111.6	154	0.00 *	1.41	22.8
BERWYN INCOME BERIX 1	B+	Domestic Hybrid	A	198.2	54	0.00 *	0.67	8.0
BJURMAN BARRY MICRO CAP GROWTH BMCFX	A	Small-cap Growth	A	647.9	-31	No load ‡	1.46 †	3.4
BOGLE SMALL CAP GROWTH INV. BOGLX	B+	Small-cap Growth	A	147.3	12	No load ‡	1.35	10.8
BOSTON PARTNERS LONG SHORT EQUITY INV. BPLEX	A	Miscellaneous	A	16.2	5	0.00 * ‡	2.75 †	8.0
BOSTON PARTNERS SMALL CAP VALUE II INV. BPSCX	A	Small-cap Value	A	385.5	35	0.00 * ‡	1.74 †	16.5
BRAZOS REAL ESTATE SECURITIES Y BJRSX	A	Real Estate	C-	21.2	-69	No load	1.16	29.9
BRIDGEWAY MICRO CAP LIMITED BRMCX	A	Small-cap Blend	B+	60.3	-16	No load ‡	1.79	9.5

*Includes redemption fee. **Includes deferred sales charge. †12(b)-1 plan in effect. ‡Closed to new investors. NA=Not available.
 (a) Formerly INVESCO Energy Fund Inv. (b) Formerly INVESCO Gold & Precious Metals Fund Inv.

ly other assets. World funds generally e U.S. stocks; foreign funds do not. Sector gional funds are as indicated.

CHARGE Many funds take this "load" out initial investment, and for ratings es, returns are reduced by these charges. may be levied on withdrawals.

SE RATIO This counts expenses as a tage of average net assets. Footnotes a 12(b)-1 plan, which uses shareholder for marketing. The average is 1.38%.

X TOTAL RETURN A fund's net gain to rs, including reinvestment of dividends pital gains at month-end prices.

TAX TOTAL RETURN Returns adjusted for es; treats all capital gains and long-term. ncome as a percent of net asset value.

HISTORY A fund's returns relative to other equity funds for, from left to right, 2000, 2001, 2002, 2003, and 2004. The numbers designate which quintile the fund was in during the period: 1 for the top quintile, 2 for the second, and so on. No number indicates that there are no data for that period.

TURNOVER The relative frequency of a fund's trading activity.

CASH Portion of fund not in stocks or bonds. If negative, the fund is using borrowed money.

UNTAXED GAINS Percentage of assets in portfolio that are unrealized and undistributed capital gains. A negative figure indicates losses that may offset future gains.

P-E RATIO The average price-earnings ratio of the fund derived from each stock price divided by reported per-share earnings.

TOP 10 STOCKS The percentage of fund assets that represents the 10 largest holdings. The higher the number, the more concentrated the fund, and the more dependent on the performance of a relatively small number of stocks.

LARGEST HOLDING From the latest fund reports.

RISK The risk-of-loss factor, or potential for losing money, calculated as follows: The three-month Treasury bill return is subtracted from the monthly return in each of the last 60 months. When a fund has lagged Treasury bills, the result is negative. The sum of these negative numbers is divided by the number of months. The result is a negative number, and the greater its magnitude, the higher the risk of loss.

BEST AND WORST QUARTERS Highest and lowest quarterly returns of the past five years.

AL TOTAL RETURNS (%)				HISTORY		PORTFOLIO DATA						RISK				TELEPHONE		
5 YEARS		10 YEARS		RESULTS VS. ALL FUNDS		TURNOVER	CASH %	UNTAXED GAINS%	P-E RATIO	TOP 10 STKS%	LARGEST HOLDING COMPANY (% ASSETS)	LEVEL	BEST		WORST			
PRETAX	AFTERTAX	PRETAX	AFTERTAX										QTR	% RET	QTR	% RET		
15.3	14.3	15.0	14.0	111321	Average	7	18	24	39	Readers Digest Association (5)	Average	Q2 03	30.1	Q3 02	-19.5	800-992-8151		
21.3	19.5	NA	NA	111121	Very Low	1	31	31	42	Simon Property Group (5)	Very Low	Q4 04	17.0	Q3 02	-8.4	800-992-8151		
1.3	1.1	NA	NA	144344	Average	5	4	21	38	American Express (5)	Average	Q2 03	20.1	Q3 01	-20.0	800-243-9865		
0.9	0.7	NA	NA	234255	Low	7	-1	22	32	Microsoft (3)	Average	Q2 03	17.8	Q3 02	-21.9	800-243-9865		
16.1	15.7	15.0	14.0	141151	High	NA	26	16	37	BP Amoco PLC Sponsored ADR (5)	Average	Q1 00	21.4	Q3 01	-16.9	800-347-4246		
17.9	17.5	1.0	0.0	311115	Average	NA	-94	38	50	Glamis Gold (6)	High	Q1 02	33.9	Q2 04	-14.3	800-347-4246		
24.0	22.7	NA	NA	111121	Average	NA	26	28	48	General Growth Properties (6)	Very Low	Q4 04	17.1	Q3 02	-6.3	800-347-4246		
20.6	19.6	NA	NA	111123	Low	NA	14	NA	NA	Prime Hospitality (3)	Very Low	Q2 03	21.0	Q3 02	-9.2	800-528-3780		
16.2	15.8	NA	NA	214112	Very Low	3	25	21	8	SEI Daily Income Trust Govt. Port. (3)	Average	Q2 03	31.0	Q3 02	-27.8	888-263-6443		
22.1	20.5	NA	NA	111121	Average	25	23	34	45	ProLogis (7)	Very Low	Q4 04	16.5	Q3 02	-8.9	800-221-5672		
21.1	19.2	NA	NA	111121	Low	NA	22	NA	NA	ProLogis (7)	Very Low	Q4 04	16.7	Q3 02	-9.3	800-221-5672		
17.8	17.2	9.0	9.0	221111	Average	10	26	NA	42	Diamond City (4)	Low	Q2 03	21.5	Q3 02	-15.9	888-785-5578		
24.5	22.2	NA	NA	111131	Average	10	21	27	32	iStar Financial (4)	Very Low	Q2 00	16.0	Q3 02	-4.5	888-785-5578		
32.0	31.6	20.0	19.0	111111	High	3	26	13	49	Hovnanian Enterprises Class A (5)	Low	Q2 03	34.2	Q3 02	-19.0	888-785-5578		
8.8	8.6	NA	NA	211144	Average	2	14	20	64	Home Depot (8)	Low	Q4 00	17.3	Q3 02	-9.0	800-451-8382		
8.5	7.1	10.0	8.0	211153	High	7	9	16	20	Bank of America (2)	Very Low	Q2 03	13.7	Q3 02	-10.8	800-967-9009		
22.5	21.4	NA	NA	111111	High	13	6	15	19	Valassis Communications (1)	Low	Q2 03	24.8	Q3 02	-20.9	800-967-9009		
18.9	18.6	2.0	1.0	511115	Low	NA	12	34	58	Newmont Mining (10)	High	Q1 02	40.2	Q2 04	-17.9	800-345-2021		
21.9	20.3	NA	NA	111121	Very High	3	20	34	46	Simon Property Group (7)	Very Low	Q4 04	12.8	Q3 02	-7.3	800-345-2021		
21.7	20.8	NA	NA	111221	High	5	21	19	18	Sybase (3)	Very Low	Q2 03	18.6	Q3 02	-19.0	800-345-2021		
16.5	15.9	NA	NA	211111	High	NA	22	14	13	NVR (2)	Low	Q2 03	22.3	Q3 02	-15.5	800-345-2021		
11.5	10.4	14.0	11.0	111232	High	2	11	16	26	Union Pacific (4)	Low	Q2 03	15.7	Q3 02	-16.3	800-345-2021		
9.5	8.1	12.0	9.0	111154	Average	6	11	18	14	General Electric (2)	Very Low	Q2 03	12.8	Q3 02	-11.5	800-421-0180		
3.2	0.7	NA	NA	145335	High	NA	-234	61	59	XM Satellite Radio Holdings Class A (22)	High	Q1 00	37.4	Q2 02	-32.9	800-370-0612		
5.9	3.9	NA	NA	145332	High	NA	-134	55	69	XM Satellite Radio Holdings Class A (27)	High	Q1 00	29.6	Q2 02	-23.7	800-370-0612		
16.8	15.8	16.0	14.0	111141	Low	18	21	19	46	Caesars Entertainment (4)	Low	Q2 03	17.6	Q3 02	-10.2	800-292-7435		
18.8	17.1	16.0	14.0	111221	High	2	23	21	14	Cott (2)	Low	Q4 01	19.3	Q3 02	-17.8	800-622-3863		
0.3	-0.2	8.0	6.0	233354	Very Low	14	47	23	56	Medtronic (7)	Low	Q2 03	11.6	Q2 02	-13.2	214-720-9101		
7.2	7.0	NA	NA	124332	Average	3	18	26	16	Aetna New (2)	High	Q1 00	26.1	Q3 01	-22.5	800-344-1770		
17.7	16.6	NA	NA	111121	Average	6	26	13	31	Kellwood (3)	Very Low	Q4 03	19.3	Q3 02	-16.4	800-344-1770		
8.9	8.5	NA	NA	211143	Low	20	12	15	34	Citigroup (2)	Very Low	Q2 03	15.6	Q3 02	-8.3	800-862-7283		
4.7	3.4	10.0	9.0	223342	Low	12	29	20	42	Citigroup (4)	Low	Q4 01	16.1	Q2 02	-14.4	800-474-6657		
17.7	16.3	11.0	10.0	211111	Low	NA	24	20	36	Westmoreland Coal (5)	Low	Q4 03	22.6	Q3 02	-18.6	800-992-6757		
10.7	8.5	9.0	6.0	211154	Average	6	1	17	20	Thomas & Betts Nt. (2)	Very Low	Q2 03	7.3	Q2 04	-2.4	800-992-6757		
19.9	19.1	NA	NA	111315	Low	NA	54	23	20	Immucor (2)	High	Q1 00	34.3	Q3 02	-19.0	800-227-7264		
14.1	13.6	NA	NA	111313	Average	NA	23	23	11	Vintage Petroleum (1)	Average	Q2 03	24.3	Q3 02	-19.0	877-264-5346		
15.9	15.5	NA	NA	111154	High	NA	-3	37	44	Comtech Telecommunications (6)	Very Low	Q4 00	18.3	Q3 02	-9.1	888-261-4073		
26.1	25.4	NA	NA	111212	Average	NA	27	19	19	Apria Healthcare Group (3)	Low	Q2 03	29.2	Q3 02	-21.2	888-261-4073		
20.3	16.7	NA	NA	111131	High	NA	33	32	34	iShares Tr. Cohen & Steers Realty (5)	Very Low	Q4 04	14.9	Q3 02	-8.0	800-426-9157		
16.0	14.3	NA	NA	211214	Average	4	33	16	33	SS&C Technologies (4)	Average	Q2 03	30.3	Q3 02	-20.5	800-661-3550		

Data: Standard & Poor's

Personal Business Mutual Funds

FUND/SYMBOL	OVERALL RATING (COMPARES RISK-ADJUSTED PERFORMANCE OF EACH FUND AGAINST ALL FUNDS)	CATEGORY	RATING (COMPARES RISK-ADJUSTED PERFORMANCE OF FUND WITHIN CATEGORY)	SIZE ASSETS \$ MIL.	% CHG. 2003-2004	FEES SALES CHARGE (%)	EXPENSE RATIO (%)	2004 RET PRE- TAX
BRIDGEWAY ULTRA SMALL COMPANY BRUSX	A	Small-cap Blend	A	113.2	12	No load ‡	1.15	23.3
BRIDGEWAY ULTRA SMALL COMPANY MARKET BRSIX	A	Small-cap Value	A	773.2	7	0.00 * ‡	0.67	19.1
BRUCE BRUFEX	A	Domestic Hybrid	A	27.7	272	No load	1.17	57.2
BUFFALO LARGE CAP BUFEX	C	Large-cap Growth	A	56.8	10	No load	1.04	7.8
BUFFALO SMALL CAP BUFEX	A	Small-cap Blend	A	1877.9	26	No load ‡	1.01	28.8
BUFFALO USA GLOBAL BUFGX	C	Large-cap Growth	A	85.5	15	No load	1.03	7.1
BURNHAM FINANCIAL SERVICES A BURKX	A	Financial	A	194.9	-27	5.00 * ‡	1.50 †	13.1
CGM FOCUS CGMFX	A	Small-cap Value	A	956.0	38	No load	1.18	12.3
CGM REALTY CGMRX	A	Real Estate	A	697.5	6	No load	1.02	35.2
CNI CHARTER RCB SMALL CAP VALUE R RCBSX	A	Small-cap Value	C	43.3	173	3.50	1.49 †	19.4
CRM SMALL CAP VALUE INSTITUTIONAL CRISX	A	Small-cap Value	B	434.5	65	No load ‡	0.97	18.1
CALVERT SOCIAL INV. EQUITY A CSIX	B	Large-cap Blend	A	747.7	28	4.75 *	1.29 †	6.7
CENTURY SHARES CENSX	B+	Large-cap Value	A	348.9	0	0.00 *	1.17	12.5
CHASE GROWTH CHASX	C	Large-cap Growth	A	205.1	75	0.00 *	1.42	16.9
CHESAPEAKE CORE GROWTH CHCGX	C	Large-cap Growth	A	320.4	297	No load	1.31 †	10.7
CLIPPER CFIMX	B+	Large-cap Value	A	7063.2	8	No load	1.13	5.9
COHEN & STEERS REALTY FOCUS INSTITUTIONAL CSSPX (c)	D	Real Estate	D	61.2	136	0.00 *	1.50	41.0
COHEN & STEERS REALTY INCOME C CSCIX (d)	A	Real Estate	C	691.3	40	0.00 **	1.94 †	24.9
COHEN & STEERS REALTY SHARES CSRSX	A	Real Estate	B	2157.7	33	0.00 *	1.07	38.5
COLUMBIA ACORN Z ACRNX	B+	Small-cap Growth	A	8415.5	24	No load	0.80	21.5
COLUMBIA REAL ESTATE EQUITY Z CREEX	A	Real Estate	C-	930.4	-2	No load	0.97	31.1
COLUMBIA SMALL CAP Z SMCEX	A	Small-cap Value	C	1186.9	28	No load ‡	0.90	16.6
COMMONWEALTH NEW ZEALAND CNZLX	B+	Foreign	A	43.9	14	No load	2.53 †	7.9
CONSULTING GROUP CAP MKTS. SMALL CAP VALUE EQ. TSVUX	A	Small-cap Value	C	475.9	7	No load	1.16	23.6
DAVIS REAL ESTATE A RPERX	A	Real Estate	D	293.3	61	4.75	1.30 †	33.2
DELAFIELD DEFEX	A	Small-cap Value	B	335.7	44	0.00 *	1.32 †	20.8
DELAWARE AMERICAN SERVICES A DASAX	A	Mid-cap Blend	A	78.7	323	5.75	1.38 †	23.3
DELAWARE DIVIDEND INCOME A DDIA	B	Domestic Hybrid	A	104.9	1718	5.75	0.79 †	10.4
DELAWARE REAL ESTATE INV. TRUST A DPREX	A	Real Estate	C-	323.7	23	5.75	1.40 †	31.0
DIAMOND HILL BANK & FINANCIAL A BANCX	A	Financial	B+	19.3	68	5.75	1.70 †	16.7
DODGE & COX BALANCED DODBX	B+	Domestic Hybrid	A	20091.0	64	No load ‡	0.54	13.3
DODGE & COX STOCK DODGX	B+	Large-cap Value	A	41436.2	57	No load ‡	0.54	19.2
DREYFUS PREMIER ALPHA GROWTH FUND T BSFAX (e)	C	Large-cap Growth	A	124.5	62	4.50	1.40 †	6.9
DREYFUS PREMIER BALANCED OPPORTUNITY J THPBX (f)	B+	Domestic Hybrid	A	245.2	13	No load	1.07	7.0
DREYFUS PREMIER SMALL CAP VALUE A DSVAX	A	Small-cap Value	C	142.2	350	5.75	1.50 †	25.3
EII REALTY SECURITIES INSTITUTIONAL EIIRX	A	Real Estate	C-	106.0	-8	No load	1.00	34.5
EMERALD SELECT BANKING & FINANCE A HSSAX	A	Financial	B+	167.5	59	4.75	1.74 †	20.7
EQUITRUST MANAGED B FBMGX	B+	Domestic Hybrid	A	37.5	3	0.00 **	1.79 †	7.5
EVERGREEN HEALTH CARE A EHABX	A	Health	A	95.6	62	5.75	2.03 †	8.2
EVERGREEN PRECIOUS METALS A EKWAX (g)	A	Precious Metals	B	213.9	4	5.75 *	1.44 †	-5.8
EXCELSIOR REAL ESTATE UMREX	A	Real Estate	C	131.8	25	No load	1.20	29.8
EXETER PRO BLEND EXTENDED TERM A MNBAX	B+	Domestic Hybrid	A	288.6	35	No load	1.17	11.0
EXETER TAX MANAGED A EXTAX	B	Large-cap Blend	A	6.5	31	No load	1.20	17.3
FBR LARGE CAP FINANCIAL FBRFX (h)	A	Financial	B	31.2	-14	0.00 *	1.92 †	11.7
FBR SMALL CAP FBRVX (i)	A	Small-cap Growth	A	931.3	165	0.00 *	1.60 †	30.7
FBR SMALL CAP FINANCIAL FBRSX (j)	A	Financial	A	666.2	14	0.00 *	1.57 †	16.0
FMC STRATEGIC VALUE	A	Small-cap Value	B+	90.9	61	No load	1.30	19.7
FAIRHOLME FAIRX	A	All Cap	A	234.7	165	0.00 *	1.00	24.9
FEDERATED KAUFMANN K KAUFEX	B+	Mid-cap Growth	A	3719.6	6	0.00 *	1.95 †	14.3
FIDELITY ASSET MANAGER AGGRESSIVE FAMRX	C	Large-cap Growth	A	379.7	28	No load	0.91	11.0
FIDELITY CANADA FICDX	B+	Foreign	A	563.6	206	0.00 *	1.37	23.9
FIDELITY CONTRA FCNTX	C	Large-cap Growth	A	42839.7	22	No load	0.98	15.1
FIDELITY DISCIPLINED EQUITY FDEQX	C	Large-cap Growth	A	4756.1	25	No load	0.90	12.0
FIDELITY EXPORT & MULTINATIONAL FEXPX	B	Large-cap Blend	A	1541.6	63	0.00 *	0.83	13.6
FIDELITY LOW PRICED STOCK FLPSX	A	Small-cap Value*	B+	34416.1	38	0.00 * ‡	0.97	22.2
FIDELITY REAL ESTATE INVESTMENT FRESX	A	Real Estate	B+	4182.9	62	0.00 *	0.83	34.2
FIDELITY SELECT CONSTRUCTION & HOUSING FSHOX (k)	A	Miscellaneous	A	111.9	-10	0.00 *	1.35	28.5
FIDELITY SELECT HOME FINANCE FSVLX (l)	A	Financial	B+	423.6	0	0.00 *	1.10	13.2
FIDELITY SELECT MEDICAL DELIVERY FSHCX (m)	A	Health	A	282.8	55	0.00 *	1.24	45.5
FIDELITY SELECT MEDICAL SYSTEMS & EQUIPMENT FSMEX (n)	A	Health	B+	794.9	123	0.00 *	1.15	17.5
FIDELITY SELECT NATURAL GAS FSNEX (o)	A	Natural Resources	B	619.0	240	0.00 *	1.14	40.2
FIDELITY SELECT SOFTWARE & COMPUTER FSCSX (p)	C-	Technology	A	809.3	0	0.00 *	1.06	7.6
FIFTH THIRD MICRO CAP VALUE INSTITUTIONAL MXAIX	A	Small-cap Value	B+	159.3	14	No load	1.33	23.2
FIFTH THIRD STRATEGIC INCOME INSTITUTIONAL MXIIX	B+	Domestic Hybrid	A	96.8	14	No load	1.33	6.5
FIRST AMERICAN MID CAP GROWTH OPPORTUNITY Y FISGX	B+	Mid-cap Growth	A	1247.1	-1	No load	0.95	21.6
FIRST AMERICAN REAL ESTATE SECURITIES Y FARCX	A	Real Estate	B+	481.2	109	No load	0.98	32.5
FIRST EAGLE GLOBAL A SGENX	A	International Hybrid	A	6651.4	92	5.00 *	1.32 †	18.4
FIRST EAGLE GOLD A SGGDX	A	Precious Metals	B+	566.6	34	5.00 *	1.49 †	-5.1
FIRST EAGLE OVERSEAS A SGOVX	A	Foreign	A	4085.4	56	5.00 * ‡	1.31 †	21.8
FIRST FOCUS BALANCED FOBAX	B	Domestic Hybrid	A	24.7	-4	No load	1.07	15.0

*Includes redemption fee. **Includes deferred sales charge. †12(b)-1 plan in effect. ‡Closed to new investors. NA=Not available.

(c) Formerly Cohen & Steers Special Equity (d) Formerly Cohen & Steers Equity Income C (e) Formerly Bear Stearns Alpha Growth Fund A (f) Formerly Thompson Plumb Balanced Fund (g) green Precious Metals Holdings A (h) Formerly FBR Large Cap Financial Fund A (i) Formerly FBR Small Cap Fund A (j) Formerly FBR Small Cap Financial Fund A (k) Formerly Select Constr (l) Formerly Select Home Finance (m) Formerly Select Medical Delivery (n) Formerly Select Medical Systems & Equipment (o) Formerly Select Natural Gas (p) Formerly Select Software & C

ANNUAL TOTAL RETURNS (%)				HISTORY	PORTFOLIO DATA								RISK	TELEPHONE			
5 YEARS		10 YEARS		RESULTS VS. ALL FUNDS	TURNOVER	CASH %	UNTAXED GAINS%	P-E RATIO	TOP10 STKS.%	LARGEST HOLDING COMPANY (% ASSETS)	LEVEL	BEST		WORST			
PRETAX	AFTERTAX	PRETAX	AFTERTAX									QTR	%RET	QTR	%RET		
27.7	25.4	26.0	24.0	211111	Average	6	40	23	35	SFBC International (6)	Low	Q2 03	34.5	Q3 02	-16.4	800-661-3550	
22.9	22.8	NA	NA	311111	Low	NA	44	23	12	iShares Trust Russell 2000 Index Fd. (3)	Low	Q2 03	30.9	Q3 02	-14.4	800-661-3550	
37.2	34.6	22.0	20.0	111111	Average	17	28	27	48	U.S. Treasury Strips 8/2028 (6)	Very Low	Q2 03	29.9	Q2 00	-5.6	800-872-7823	
1.5	1.1	NA	NA	144342	Low	8	8	20	35	American Express (5)	Average	Q2 03	20.5	Q2 02	-20.0	800-492-8332	
20.5	19.8	NA	NA	114111	Low	2	22	24	28	Warner Chilcott U.K. (4)	Average	Q2 03	30.4	Q3 02	-23.0	800-492-8332	
1.1	0.6	NA	NA	234424	Low	7	14	22	28	American Intl. Group (3)	Average	Q2 03	17.4	Q3 02	-19.6	800-492-8332	
29.9	27.8	NA	NA	111123	High	10	14	NA	39	North Fork Bancorporation N.Y.C. (5)	Very Low	Q3 00	26.5	Q3 01	-4.8	800-462-2392	
28.4	27.4	NA	NA	111313	Very High	NA	14	13	54	Mobile Telesystems OJSC ADR (6)	High	Q4 00	44.4	Q3 02	-21.3	800-343-5678	
29.2	27.2	20.0	17.0	111111	High	1	46	11	69	Hovnanian Enterprises Class A (9)	Low	Q2 03	36.1	Q3 02	-16.2	800-343-5678	
16.6	16.2	NA	NA	211211	Average	3	21	13	37	SBS Broadcasting (4)	Low	Q2 03	27.7	Q3 02	-20.2	888-889-0799	
16.7	15.7	NA	NA	111312	High	3	21	22	24	Insight Enterprises (3)	Low	Q2 03	27.4	Q3 02	-19.3	800-276-2883	
4.5	4.2	11.0	10.0	222255	Average	0	19	22	30	Amgen (4)	Low	Q4 01	15.2	Q3 02	-16.2	800-368-2748	
10.5	8.6	13.0	11.0	112243	Average	NA	51	16	39	American International Group (5)	Low	Q3 00	26.9	Q3 02	-15.1	800-321-1928	
1.1	1.1	NA	NA	242232	High	5	15	19	35	UnitedHealth Group (5)	Low	Q4 03	10.6	Q1 01	-10.1	888-861-7556	
2.2	1.7	NA	NA	234423	Average	NA	10	23	29	St. Jude Medical (4)	High	Q2 03	18.9	Q3 01	-21.6	800-773-3863	
12.6	11.3	16.0	14.0	111155	Low	20	11	18	62	Freddie Mac (9)	Very Low	Q2 03	17.3	Q3 02	-12.3	800-776-5033	
19.2	17.8	NA	NA	211111	Very High	NA	-6	51	56	Avalonbay Communities (7)	Low	Q2 03	19.0	Q3 02	-10.0	800-437-9912	
20.7	18.4	NA	NA	111121	Low	NA	29	35	32	Arden Realty (4)	Very Low	Q2 03	13.3	Q3 02	-6.9	800-437-9912	
21.3	19.2	15.0	12.0	111121	Average	NA	43	32	45	Boston Properties (7)	Very Low	Q4 04	17.6	Q3 02	-8.8	800-437-9912	
12.4	11.4	16.0	14.0	211211	Very Low	6	7	26	11	International Game Technology (2)	Low	Q2 03	20.0	Q3 01	-18.6	800-345-6611	
20.0	18.1	15.0	13.0	111121	Average	1	45	32	42	iStar Financial (5)	Very Low	Q4 04	15.5	Q3 02	-9.9	800-345-6611	
15.7	14.1	17.0	14.0	111122	Low	7	22	22	18	iShares Trust Russell 2000 Index (3)	Low	Q2 03	19.6	Q3 02	-17.7	800-345-6611	
10.0	9.9	6.0	5.0	511124	Average	10	25	NA	27	GPG Finance (2)	Average	Q4 01	14.8	Q1 00	-12.8	888-345-1898	
15.5	14.4	14.0	12.0	111221	Average	3	33	21	18	Input/Output (2)	Low	Q2 03	20.0	Q3 02	-20.3	800-221-8806	
20.9	19.5	15.0	13.0	111221	Average	5	33	26	42	Centerpoint Properties Trust (7)	Very Low	Q4 04	15.0	Q3 02	-8.0	800-279-0279	
18.7	17.7	15.0	14.0	111121	High	1	20	NA	42	Thermo Electron (4)	Low	Q2 03	22.9	Q3 02	-18.3	800-433-1918	
21.3	19.7	NA	NA	111111	Very High	8	14	20	31	Getty Images (5)	Average	Q1 00	33.8	Q3 02	-15.9	800-362-7500	
8.8	7.3	NA	NA	211144	Very High	NA	4	NA	14	Kerr McGee (2)	Very Low	Q2 03	12.2	Q3 02	-9.5	800-362-7500	
21.3	19.3	NA	NA	111131	Average	NA	29	NA	NA	Simon Property Group (6)	Very Low	Q4 04	14.5	Q3 02	-8.9	800-362-7500	
20.9	19.6	NA	NA	111122	Average	18	21	15	45	Allstate (4)	Very Low	Q2 03	18.1	Q3 02	-10.1	888-226-5595	
11.6	9.7	13.0	11.0	111143	Average	12	17	17	20	United States Treasury Bills (2)	Very Low	Q2 03	12.3	Q3 02	-8.9	800-621-3979	
12.4	10.8	16.0	15.0	111231	Very Low	4	24	15	24	Hewlett-Packard (3)	Low	Q2 03	16.6	Q3 02	-15.8	800-621-3979	
1.6	1.3	NA	NA	411145	Average	1	9	20	25	Countrywide Financial (3)	Average	Q4 01	17.0	Q3 02	-13.1	800-645-6561	
7.7	6.4	12.0	10.0	211155	Average	4	NA	18	21	Cardinal Health (2)	Low	Q2 03	15.6	Q3 02	-12.4	800-645-6561	
17.0	16.6	NA	NA	111111	Very High	5	10	17	11	The Houston Exploration Co. (1)	Low	Q2 03	25.4	Q3 02	-19.4	800-645-6561	
19.9	17.5	NA	NA	111131	High	NA	45	31	46	Simon Property Group (6)	Very Low	Q4 04	16.2	Q3 02	-9.1	888-323-8912	
21.6	21.1	NA	NA	111111	Low	NA	25	19	23	Commercial Cap Bancorp (3)	Very Low	Q2 01	14.8	Q3 02	-7.7	800-232-0224	
10.6	9.9	8.0	6.0	111134	Low	34	11	17	27	ConocoPhillips (3)	Very Low	Q2 03	12.3	Q3 02	-8.3	877-860-2904	
22.4	20.5	NA	NA	111414	High	1	12	30	30	Pfizer (4)	Average	Q1 00	53.6	Q1 01	-21.3	800-343-2898	
24.2	23.9	NA	NA	411155	High	NA	14	34	46	Placer Dome (7)	High	Q1 02	37.4	Q2 04	-18.2	800-343-2898	
20.9	19.0	NA	NA	111131	Average	4	30	31	36	Simon Property Group (4)	Very Low	Q4 04	14.7	Q3 02	-9.0	800-446-1012	
7.7	6.6	11.0	9.0	111153	Average	5	12	27	48	U.S. Treasury Bonds 5.5% 2028 (7)	Very Low	Q2 03	11.9	Q2 02	-10.1	800-466-3863	
4.7	4.4	NA	NA	133442	Average	8	20	27	38	Schering Plough (5)	Low	Q2 03	14.4	Q3 02	-15.4	800-466-3863	
15.5	14.6	NA	NA	121133	Average	5	29	13	58	Astoria Financial (8)	Low	Q3 00	27.4	Q3 02	-12.1	800-888-0025	
18.8	18.5	NA	NA	411111	Very Low	23	22	21	46	Markel (9)	Low	Q2 01	30.9	Q3 01	-13.4	800-888-0025	
26.1	25.0	NA	NA	111122	Low	21	29	17	57	Firstfed Financial Del. (6)	Very Low	Q3 00	16.5	Q1 00	-8.0	800-888-0025	
18.9	17.6	NA	NA	111131	Very Low	21	15	24	40	Range Resources (5)	Low	Q4 01	16.2	Q3 02	-12.0	866-777-7818	
18.9	18.6	NA	NA	111151	Low	20	20	NA	64	Leucadia National (16)	Very Low	Q3 00	20.7	Q1 03	-6.0	866-202-2263	
9.3	7.2	13.0	11.0	211312	Low	5	9	25	27	Petsmart (5)	Average	Q2 03	28.2	Q3 02	-14.0	800-341-7400	
0.9	0.3	NA	NA	145113	Average	8	-28	26	29	Genentech (3)	High	Q1 00	25.9	Q3 01	-21.4	800-544-8544	
12.8	12.4	12.0	11.0	231111	Average	2	18	NA	35	Canadian Imperial Bk. of Commerce O (5)	Low	Q2 03	18.6	Q1 01	-14.4	800-544-8544	
1.6	1.0	13.0	12.0	331142	Average	10	7	22	28	Avon Products (3)	Low	Q2 03	11.8	Q1 01	-13.2	800-544-8544	
-0.8	-1.4	11.0	9.0	343443	Average	3	10	17	24	ExxonMobil (3)	Average	Q2 03	13.3	Q3 02	-14.4	800-544-8544	
4.6	3.3	17.0	15.0	323333	High	1	14	20	31	American International Group (6)	Average	Q2 03	16.7	Q3 02	-16.8	800-544-8544	
19.5	18.0	17.0	16.0	111121	Low	14	33	NA	26	D.R. Horton (2)	Very Low	Q2 03	21.3	Q3 02	-17.0	800-544-8544	
22.3	20.3	15.0	12.0	111131	Average	3	32	27	54	Starwood Hotels & Resorts World. (7)	Very Low	Q4 04	16.6	Q3 02	-8.8	800-544-8544	
17.2	17.0	16.0	15.0	211111	Low	9	25	13	50	Countrywide Financial (5)	Average	Q4 01	25.4	Q3 02	-22.4	800-544-8544	
17.5	16.4	17.0	16.0	121123	Average	3	34	13	52	Golden West Financial Del. (9)	Low	Q3 00	31.0	Q3 02	-16.5	800-544-8544	
22.2	22.2	12.0	11.0	122331	High	4	15	16	76	UnitedHealth Group (18)	Low	Q4 04	29.8	Q4 02	-20.5	800-544-8544	
17.3	16.3	NA	NA	121132	Low	2	19	32	52	Medtronic (8)	Very Low	Q2 00	15.3	Q1 01	-12.5	800-544-8544	
16.6	16.4	14.0	14.0	151141	High	1	18	21	48	Nabors Industries (6)	Average	Q1 00	22.4	Q3 01	-16.2	800-544-8544	
-3.7	-5.2	16.0	14.0	534424	Average	8	-17	31	65	Microsoft (16)	Very High	Q4 01	53.7	Q3 01	-41.1	800-544-8544	
20.5	19.5	NA	NA	311111	Low	4	41	31	21	Symmetricon (3)	Low	Q2 03	31.4	Q3 02	-20.7	800-282-5706	
11.0	9.0	NA	NA	111155	Average	1	5	NA	13	Citigroup Capital VII Sec. 7.125% T (2)	Very Low	Q2 00	6.6	Q2 04	-5.0	800-282-5706	
10.8	8.7	12.0	10.0	122331	Low	6	20	25	28	NCR New (4)	Average	Q4 01	18.6	Q3 01	-19.9	800-677-3863	
23.2	20.7	NA	NA	111121	High	1	23	34	37	Simon Property Group New (5)	Very Low	Q4 04	16.9	Q3 02	-7.3	800-677-3863	
16.8	15.0	13.0	11.0	211122	Very Low	19	23	20	29	Rayonier (2)	Very Low	Q2 03	15.7	Q3 02	-8.2	900-451-3623	
25.3	24.6	6.0	5.0	511125	Very Low	16	15	44	50	Newmont Mining (6)	Average	Q1 02	50.4	Q2 04	-17.3	800-451-3623	
16.6	15.0	14.0	12.0	211121	Very Low	16	29	20	27	Wendel Investissement (2)	Very Low	Q2 03	16.6	Q3 02	-10.5	800-451-3623	
7.6	6.9	NA	NA	211152	High	NA	18	21	32	U.S. Treasury Bonds 7.25% 5/2016 (5)	Very Low	Q2 03	11.6	Q3 02	-7.7	800-662-4203	

Data: Standard & Poor's

Personal Business Mutual Funds

FUND/SYMBOL	OVERALL RATING (COMPARES RISK-ADJUSTED PERFORMANCE OF EACH FUND AGAINST ALL FUNDS)	CATEGORY	RATING (COMPARES RISK-ADJUSTED PERFORMANCE OF FUND WITHIN CATEGORY)	SIZE ASSETS \$MIL.	% CHG. 2003-2004	FEES SALES CHARGE (%)	EXPENSE RATIO (%)	2004 RE- PRE- TAX
FORWARD UNIPLAN REAL ESTATE INV. FFREX	A	Real Estate	C-	46.4	32	0.00 *	1.91 †	28.8
FRANKLIN BALANCE SHEET INV. A FRBSX	A	Small-cap Value	C	4090.8	32	5.75 ‡	1.00 †	25.3
FRANKLIN DYNATECH A FKDNX	C-	Technology	A	659.9	8	5.75	0.97 †	7.7
FRANKLIN INCOME A FKINX	B+	Domestic Hybrid	A	16135.2	51	4.25	0.68 †	12.2
FRANKLIN UTILITIES A FKUTX	B+	Utilities	A	1567.6	22	4.25	0.80 †	23.1
FRANKLIN MICROCAP VALUE FRMCX	A	Small-cap Value	B+	443.5	30	5.75	1.23 †	16.0
FRANKLIN REAL ESTATE SECURITIES A FREEX	A	Real Estate	D	650.4	19	5.75	1.01 †	32.1
FREMONT REAL ESTATE FREFX	A	Real Estate	F	30.0	-4	No load	1.50	33.2
GMO INTERNATIONAL EQUITY ALLOCATION III GIEAX	B+	Foreign	A	457.9	229	No load	0.01	24.2
GMO INTERNATIONAL INTRINSIC VALUE IV GIMCX	B+	Foreign	A	1700.2	200	No load	0.63	25.1
GMO INTERNATIONAL SMALL COMPANIES III GIMSX	B+	Foreign	A	1614.8	27	No load ‡	0.75	27.0
GMO REAL ESTATE III GMORX	A	Real Estate	C	233.3	26	No load	0.52	30.4
GABELLI GOLD AAA GOLDX	A	Precious Metals	B	307.6	-14	0.00 *	1.55 †	-10.9
GABELLI WESTWOOD REALTY AAA WESRX	A	Real Estate	C-	18.6	29	No load	1.56 †	26.9
GATEWAY TRUST GATEWAY GATEX	B	Large-cap Blend	A	2030.7	47	No load	0.97 †	7.0
GOLDMAN SACHS GROWTH OPPORTUNITIES A GGOAX	B	Mid-cap Growth	A	708.7	42	5.50	1.49 †	15.9
GOLDMAN SACHS MID CAP VALUE A GCMAX	A	Mid-cap Value	B+	1255.9	108	5.50	1.24 †	25.4
GOLDMAN SACHS REAL ESTATE SEC A GREAX	A	Real Estate	C	263.2	49	5.50	1.44 †	34.3
GOLDMAN SACHS SMALL CAP VALUE A GSSMX	A	Small-cap Value	B+	1073.8	43	5.50 ‡	1.49 †	19.0
GREENSPRING GRSPX	B+	Domestic Hybrid	A	130.5	43	0.00 *	1.14	8.7
GROWTH FUND OF AMERICA A AGTHX	C	Large-cap Growth	A	58163.7	28	5.75	0.70 †	12.0
JOHN HANCOCK CLASSIC VALUE A PZPVX	A	Large-cap Value	A	1089.7	909	5.00	1.16 †	14.3
JOHN HANCOCK REAL ESTATE A JREAX	A	Real Estate	D	30.3	64	5.00	1.65 †	29.8
JOHN HANCOCK U.S. GLOBAL LEADERS GROWTH A USGLX	C	Large-cap Growth	A	583.1	58	5.00	1.35 †	8.5
HARRIS INSIGHT SMALL CAP VALUE N HSVAX	A	Small-cap Value	B	26.2	263	No load	1.20	28.6
HEARTLAND SELECT VALUE HRSVX	A	All Cap	A	103.4	52	No load	1.47 †	17.0
HEARTLAND VALUE HRTVX	A	Small-cap Value	B	1869.0	-14	No load ‡	1.28 †	9.1
HEARTLAND VALUE PLUS HRVIX	A	Small-cap Value	B	408.6	129	No load	1.34 †	17.0
HEITMAN REIT PBHG PBRTX (q)	A	Real Estate	C	153.9	46	No load	1.30	35.0
HENNESSY CORNERSTONE GROWTH HFCGX	B+	Small-cap Growth	A	962.0	7	0.00 *	1.27	16.6
HIBERNIA MID CAP EQUITY A HMCEX	B	Mid-cap Growth	A	92.5	40	4.50 **	1.45 †	17.6
LOU HOLLAND GROWTH LHGFX	C	Large-cap Growth	A	40.2	25	No load	1.35	11.2
HOTCHKIS & WILEY MID CAP VALUE I HWMIX	A	Mid-cap Value	A	1483.8	308	No load	1.15	25.4
HOTCHKIS & WILEY SMALL CAP VALUE I HWSIX	A	Small-cap Value	A	421.3	76	No load	1.14	27.7
ICON ENERGY ICENX	A	Natural Resources	B+	422.7	563	No load	1.40	38.2
ICON FINANCIAL ICFSX	A	Financial	B	197.4	52	No load	1.34	18.3
ICON INFORMATION TECHNOLOGY ICTEX	C-	Technology	A	341.2	4	No load	1.35	3.9
IMS CAPITAL VALUE IMSCX	B+	Mid-cap Blend	A	77.3	39	0.00 *	1.59	12.9
ING RUSSIA A LETRX	A	Diversified Emerging Markets	A	197.7	18	5.75 *	2.09 †	5.9
INCOME FUND OF AMERICA A AMECX	B+	Domestic Hybrid	A	40768.0	38	5.75	0.57 †	12.9
ISHARES MSCI AUSTRALIA INDEX EWA	B+	Foreign	A	239.3	102	No load	0.79 †	30.9
ISHARES MSCI AUSTRIA INDEX EWO	A	Europe	A	123.0	556	No load	0.77 †	70.9
IVY GLOBAL NATURAL RES. A IGNAX	A	Natural Resources	B	539.4	710	5.75	1.89 †	27.9
IVY REAL ESTATE SECURITIES A IRSAX (r)	A	Real Estate	C	112.6	40	5.50	1.46 †	34.5
JAMES SMALL CAP JASCX	A	Small-cap Value	C	15.1	37	0.00 *	1.50 †	26.2
JANUS ADVISER FOCUSED VALUE A JVVAX (s)	B+	Large-cap Value	A	5.2	77	5.75 **	1.15 †	8.0
JANUS MID CAP VALUE INV. JMCVX	A	Mid-cap Value	A	3277.8	105	No load	0.94	18.4
JENNISON HEALTH SCIENCES B PHLBX	A	Health	B+	172.7	17	0.00 **	2.17 †	29.1
JENNISON NATURAL RESOURCES A PGNAX	A	Natural Resources	B	213.8	197	5.00	1.41 †	27.1
JENSEN JENSX	B	Large-cap Growth	A	2414.7	49	No load	0.88 †	6.0
KEELEY SMALL CAP VALUE KSCVX	A	Small-cap Value	C	277.4	170	4.50	1.75 †	32.9
KENSINGTON STRATEGIC REALTY A KSRAX	A	Real Estate	B	378.5	51	5.75 *	1.77 †	26.7
LAUDUS ROSENBERG INTL. SMALL CAP INV. RISIX (t)	B+	Foreign	A	163.6	171	0.00 *	1.75 †	31.7
LAZARD INTERNATIONAL SMALL CAP OPEN LZSMX	B+	Foreign	A	42.0	142	0.00 *	1.43 †	32.0
LEGG MASON EQUITY TRUST U.S. SM. CAP VL. PRIM. LMSVX	A	Small-cap Value	C	248.9	22	No load	2.00 †	21.2
LEGG MASON GROWTH TRUST PRIMARY LMGTX (u)	C	Large-cap Blend	A	373.1	13	No load	1.88 †	7.5
LEUTHOLD CORE INVESTMENT LCORX	B+	Domestic Hybrid	A	567.2	40	No load	1.31	8.3
LONGLEAF PARTNERS INTERNATIONAL LLINX	B+	Foreign	A	2456.1	36	No load ‡	1.68	10.2
LORD ABBETT MID CAP VALUE A LAVLX	A	Mid-cap Value	B+	6007.9	52	5.75 ‡	1.19 †	24.1
LORD ABBETT SMALL CAP VALUE A LRSCX	A	Small-cap Value	B	941.6	85	5.75 ‡	1.45 †	22.4
MFS INTERNATIONAL NEW DISCOVERY A MIDAX	B+	Foreign	A	1242.6	142	5.75 *	1.63 †	24.3
MFS STRATEGIC VALUE A MSVTX	B+	Large-cap Value	A	755.1	49	5.75	1.29 †	17.9
MP 63 DRIPX	B	Large-cap Blend	A	31.9	24	0.00 *	1.25	11.0
MAINSTAY BALANCED I MBAIX (v)	B+	Domestic Hybrid	A	195.5	25	No load	0.99	13.0
MAIRS & POWER BALANCED MAPOX	B+	Domestic Hybrid	A	86.2	44	No load	0.94	11.4
MATTHEWS ASIAN GROWTH & INCOME MACSX	A	Pacific/Asia ex-Japan	A	1180.9	45	0.00 * ‡	1.45	21.4
MATTHEWS CHINA MCHFX	B+	Pacific/Asia ex-Japan	A	388.3	72	0.00 *	1.52	3.9
MERIDIAN GROWTH MERDX	A	Small-cap Growth	A	1523.7	115	0.00 *	0.88	14.5
MERIDIAN VALUE MVALX	A	Mid-cap Value	B+	2378.6	32	0.00 *	1.09	15.1
MERRILL LYNCH LARGE CAP CORE C MCLRX	C	Large-cap Blend	A	478.7	82	0.00 **	2.01 †	14.5

*Includes redemption fee. **Includes deferred sales charge. †12(b)-1 plan in effect. ‡Closed to new investors. NA=Not available.

(q) Formerly PBHG REIT Fund PBHG (r) Formerly Advantus Real Estate Securities Fund A (s) Formerly Janus Adviser:US Value A (t) Formerly AXA Rosenberg:Intl. Small C (u) Formerly Legg Mason Focus Trust (v) Formerly Eclipse Funds Balanced

ANNUAL TOTAL RETURNS (%)				HISTORY	PORTFOLIO DATA							RISK	TELEPHONE			
5 YEARS		10 YEARS		RESULTS VS. ALL FUNDS	TURNOVER	CASH %	UNTAXED GAINS%	P-E RATIO	TOP10 STKS.%	LARGEST HOLDING COMPANY (% ASSETS)	LEVEL	BEST		WORST		
PRETAX	AFTERTAX	PRETAX	AFTERTAX									QTR	%RET	QTR	%RET	
19.8	18.1	NA	NA	111141	Low	NA	33	28	35	Chelsea Property Group (4)	Very Low	Q4 04	15.2	Q3 02	-7.9	800-999-6809
16.7	16.0	15.0	13.0	111131	Very Low	15	36	14	32	Peabody Energy (2)	Very Low	Q4 01	14.3	Q3 02	-13.5	800-342-5236
-1.8	-2.1	12.0	11.0	443244	Very Low	4	21	29	32	eBay (5)	Average	Q2 03	16.5	Q4 00	-14.8	800-342-5236
11.9	9.3	10.0	7.0	121133	Average	15	10	NA	27	Nalco Financial Holding (3)	Very Low	Q2 03	15.4	Q3 02	-6.6	800-342-5236
11.4	9.6	10.0	7.0	132231	Low	1	23	15	36	Entergy (5)	Low	Q3 00	26.7	Q3 02	-11.9	800-342-5236
21.1	20.1	NA	NA	211122	Very Low	26	33	16	42	RTI International Metals (3)	Very Low	Q1 01	16.4	Q3 02	-14.7	800-342-5236
21.1	19.5	14.0	12.0	111121	Average	4	38	28	37	Rouse (5)	Very Low	Q2 03	15.3	Q3 02	-10.0	800-342-5236
18.2	16.4	NA	NA	211131	Average	2	21	36	38	Simon Property Group (5)	Very Low	Q4 04	16.7	Q3 02	-8.8	800-548-4539
10.1	9.1	NA	NA	321111	Average	NA	20	NA	21	GMO Int. Intrinsic Value (41)	Low	Q2 03	21.3	Q3 02	-15.1	NA
9.2	7.9	NA	NA	331111	Average	2	21	13	29	Takeda Pharmaceutical (4)	Low	Q2 03	21.5	Q3 02	-14.8	NA
15.0	13.3	10.0	8.0	231111	Average	1	33	15	14	Merck KGAA (1)	Low	Q2 03	30.1	Q3 02	-17.6	NA
20.3	18.4	NA	NA	111131	Average	3	20	31	40	Simon Property Group (6)	Very Low	Q4 04	15.2	Q3 02	-9.8	NA
21.5	21.4	4.0	4.0	411115	Low	NA	25	55	48	Newmont Mining (8)	High	Q1 02	45.4	Q2 04	-18.1	800-422-3554
20.1	18.6	NA	NA	111131	Average	NA	28	30	26	Simon Property Group (3)	Very Low	Q4 04	13.2	Q3 02	-8.2	800-422-3554
3.2	2.6	7.0	6.0	221155	Low	NA	3	18	27	General Electric (4)	Very Low	Q4 02	9.6	Q3 02	-8.5	800-354-5525
8.1	8.0	NA	NA	111532	Low	3	16	28	23	Charles River Laboratories Hldgs. (2)	Average	Q4 01	24.2	Q3 01	-22.3	800-621-2550
17.5	16.8	NA	NA	111141	Average	5	18	16	25	iStar Financial (3)	Very Low	Q4 03	14.0	Q3 02	-13.8	800-621-2550
22.0	20.2	NA	NA	111121	Low	NA	33	26	47	Starwood Hotels & Resorts World. (7)	Very Low	Q4 04	17.5	Q3 02	-11.2	800-621-2550
20.2	19.9	13.0	12.0	111111	Average	3	23	15	16	Caraustar Industries (2)	Very Low	Q2 03	20.0	Q3 02	-17.3	800-621-2550
11.3	9.7	10.0	8.0	111134	High	7	14	19	40	Bisys Group Conv. Sub. Nt. (5)	Very Low	Q4 03	12.8	Q3 02	-13.5	800-366-3863
1.8	1.2	14.0	13.0	234433	Low	10	18	24	18	Time Warner (2)	Average	Q1 00	17.6	Q3 01	-20.6	800-421-0180
17.5	17.1	NA	NA	111122	Low	NA	8	13	44	MetLife (5)	Low	Q2 03	20.5	Q3 02	-18.8	800-225-5291
20.0	18.6	NA	NA	111121	Very High	NA	26	31	38	Simon Property Group (5)	Very Low	Q4 04	15.2	Q3 02	-12.5	800-225-5291
1.4	1.4	NA	NA	232254	Low	NA	10	24	53	Dell (6)	Low	Q4 01	11.4	Q3 02	-14.3	800-225-5291
17.7	16.4	NA	NA	111221	High	1	1	14	18	UICI (2)	Low	Q2 03	20.1	Q3 02	-20.2	800-982-8782
15.8	15.5	NA	NA	111222	Average	11	21	20	34	B.F. Goodrich (3)	Low	Q2 03	23.1	Q3 02	-20.2	800-432-7856
16.8	14.9	16.0	14.0	211214	Average	4	38	23	20	Great Lakes Chemical (3)	Low	Q2 03	35.4	Q3 02	-20.3	800-432-7856
16.3	15.8	15.0	14.0	411112	High	5	17	25	28	Biosite Diagnostics (3)	Low	Q2 03	23.9	Q3 02	-17.6	800-432-7856
21.1	18.3	15.0	12.0	111121	High	4	27	31	45	Rouse (6)	Very Low	Q4 04	16.1	Q3 02	-11.0	800-433-0051
13.9	11.0	NA	NA	211112	Low	1	17	17	30	Tesoro (4)	Average	Q4 04	18.3	Q3 02	-13.7	800-966-4354
7.6	7.1	NA	NA	132332	Low	2	22	17	19	Midcap SPDR Tr. Unit (3)	Low	Q1 00	14.3	Q3 01	-15.1	800-801-2143
0.4	-0.2	NA	NA	323433	Low	1	17	20	29	General Electric (4)	Average	Q4 01	15.7	Q3 02	-15.8	800-522-2711
24.1	23.2	NA	NA	111111	Average	0	15	12	31	Electronic Data Systems New (5)	Low	Q2 03	24.0	Q3 02	-20.6	800-796-5606
28.5	27.8	17.0	15.0	111111	Average	2	23	15	39	Beazer Homes U.S.A. (5)	Low	Q2 03	24.4	Q3 02	-18.1	800-796-5606
24.4	24.0	NA	NA	121131	Average	7	17	15	36	Ultra Petroleum (5)	Average	Q1 00	29.0	Q3 01	-12.1	800-828-4881
16.0	14.4	NA	NA	111322	High	0	22	13	28	JPMorgan Chase (4)	Average	Q3 00	25.9	Q3 02	-15.7	800-828-4881
-2.3	-4.3	NA	NA	145115	Average	1	37	25	26	Cree (3)	Very High	Q2 03	34.2	Q3 01	-30.4	800-828-4881
12.1	11.0	NA	NA	311213	Average	1	21	16	35	Computer Sciences (5)	Average	Q2 03	24.3	Q3 02	-14.9	800-934-5550
28.1	28.0	NA	NA	311115	Low	NA	16	NA	63	Oil Co. Lukoil Sponsored ADR (21)	High	Q4 01	41.5	Q2 00	-25.0	800-992-0180
9.4	7.6	12.0	9.0	211143	Average	9	15	NA	14	SBC Communications (2)	Very Low	Q2 03	11.4	Q3 02	-10.3	800-421-0180
12.1	11.2	NA	NA	411111	Very Low	10	21	NA	54	BHP Billiton (9)	Low	Q4 04	19.8	Q3 01	-15.8	800-474-2737
22.6	22.2	NA	NA	421111	Low	12	20	NA	80	Erste Bank Der Oester Spark (19)	Low	Q4 04	28.9	Q3 02	-14.7	800-474-2737
19.8	19.6	NA	NA	211111	Average	4	17	NA	37	Companhia Vale Do Rio Doce (5)	Average	Q4 01	24.2	Q3 01	-21.4	800-777-6472
22.2	20.4	NA	NA	111121	Average	2	20	27	38	ProLogis (6)	Very Low	Q4 04	17.7	Q3 02	-9.0	800-777-6472
15.9	15.7	NA	NA	211111	Average	NA	39	14	42	Patina Oil & Gas (7)	Low	Q2 03	25.0	Q3 01	-1.9	800-995-2637
12.9	12.1	15.0	13.0	111144	Average	8	85	14	61	Berkshire Hathaway Class A (12)	Low	Q4 00	20.3	Q3 02	-8.8	800-525-3713
17.1	16.1	NA	NA	111222	High	17	16	18	25	Washington Federal (1)	Low	Q4 01	21.3	Q3 02	-17.7	800-525-3713
16.0	14.6	NA	NA	125221	High	0	25	54	37	Atherogenics (4)	Low	Q1 00	20.0	Q2 02	-18.7	800-225-1852
19.3	18.6	15.0	13.0	131121	Very Low	NA	27	22	35	BJ Services (5)	Average	Q1 02	20.9	Q3 01	-21.0	800-225-1852
5.6	5.0	13.0	12.0	122255	Very Low	1	11	22	48	Stryker (6)	Low	Q4 01	13.3	Q2 02	-12.4	800-992-4144
16.8	16.1	18.0	17.0	211121	Average	1	24	20	11	Texas Industries (1)	Low	Q2 03	20.2	Q3 02	-17.3	800-621-5084
23.5	20.4	NA	NA	111131	High	-27	21	37	42	Simon Property Group (6)	Very Low	Q4 04	18.3	Q2 04	-9.3	800-253-2949
12.7	11.6	NA	NA	241111	High	7	17	20	15	Salzgitter AG Salzgitter Akt. (1)	Low	Q2 03	21.7	Q3 01	-17.1	800-447-3332
9.7	9.1	NA	NA	331121	Low	1	16	17	22	Neopost (3)	Low	Q2 03	21.7	Q3 02	-16.3	800-823-6300
15.5	15.2	NA	NA	211121	Average	1	29	14	12	United Defense Industries(2)	Low	Q2 03	24.3	Q3 02	-19.9	800-822-5544
2.9	2.9	NA	NA	321114	Average	4	25	30	57	Amazon.com (7)	High	Q2 03	30.9	Q3 01	-23.5	800-822-5544
10.9	9.7	NA	NA	121114	High	6	17	19	23	NASDAQ 100 Tr. Unit (3)	Very Low	Q2 03	16.6	Q3 01	-14.0	800-273-6886
12.6	11.0	NA	NA	111324	Very Low	25	21	NA	66	Nipponkoa Insurance (7)	Low	Q2 03	30.7	Q3 02	-19.6	800-445-9469
18.3	16.9	17.0	14.0	111141	Low	NA	25	16	25	Monsanto (3)	Low	Q2 03	15.4	Q3 02	-14.7	800-201-6984
17.8	16.6	NA	NA	111211	Average	NA	19	23	21	Quanex (3)	Low	Q2 03	19.4	Q3 02	-15.0	800-201-6984
11.0	10.3	NA	NA	231111	Average	10	20	NA	23	Anglo Irish Bank Cor. Common Eur. (2)	Low	Q2 03	18.8	Q3 02	-14.9	800-225-2606
10.5	10.0	NA	NA	123442	Average	2	14	15	37	Sprint Fon Shares (5)	Average	Q2 03	20.4	Q3 02	-19.1	800-225-2606
4.7	4.5	NA	NA	222443	Low	1	16	19	29	Paychex (4)	Low	Q2 03	13.9	Q3 02	-15.1	877-676-3386
9.8	8.9	11.0	9.0	211153	Average	3	16	14	13	Edison International (1)	Very Low	Q2 03	11.2	Q3 02	-6.8	800-624-6782
7.8	6.5	13.0	11.0	121153	Low	4	30	18	24	Graco (3)	Very Low	Q2 03	11.8	Q3 02	-9.4	800-304-7404
16.8	14.9	12.0	10.0	211121	Low	0	22	NA	30	China Mobile Hong Kong Nt. Conv. (5)	Very Low	Q4 01	15.3	Q3 01	-8.6	800-789-2742
12.3	11.6	NA	NA	311115	Low	NA	7	NA	35	China Mobile Hong Kong Shares (5)	Average	Q2 01	21.5	Q3 01	-27.1	800-789-2742
15.4	13.6	14.0	12.0	111312	Very Low	NA	19	NA	NA	Granite Construction (3)	Low	Q2 03	21.0	Q3 02	-18.5	800-446-6662
15.5	14.6	21.0	19.0	111222	Average	NA	16	NA	NA	Host Marriott (2)	Low	Q4 01	17.5	Q3 02	-14.8	800-446-6662
2.8	2.8	NA	NA	323332	High	NA	11	25	25	Johnson & Johnson (3)	Average	Q1 00	15.5	Q3 02	-15.9	800-637-3863

Data: Standard & Poor's

Personal Business Mutual Funds

FUND/SYMBOL	OVERALL RATING (COMPARES RISK-ADJUSTED PERFORMANCE OF EACH FUND AGAINST ALL FUNDS)	CATEGORY	RATING (COMPARES RISK-ADJUSTED PERFORMANCE OF FUND WITHIN CATEGORY)	SIZE ASSETS \$MIL.	% CHG. 2003-2004	FEES SALES CHARGE (%)	EXPENSE RATIO (%)	2004 RET. PRE- TAX
MERRILL LYNCH NATURAL RESOURCES A MDGRX	A	Natural Resources	C	92.8	52	5.25	1.25 †	30.7
MORGAN STANLEY INSTL. EUROPEAN REAL ESTATE A MSUAX	A	Miscellaneous	A	45.1	90	0.00 *	1.00	47.5
MORGAN STANLEY INSTL. INTL. EQUITY A MSIQX	B+	Foreign	A	6966.7	36	0.00 * ‡	1.00	20.0
MORGAN STANLEY INSTL. INTL. SMALL CAP A MSISX	B+	Foreign	A	1253.1	48	0.00 * ‡	1.15	33.5
MORGAN STANLEY INSTL. U.S. REAL ESTATE A MSUSX	A	Real Estate	B	1074.0	23	No load	1.00	37.3
MORGAN STANLEY INSTITUTIONAL VALUE ADV. MPVAX	B+	Large-cap Value	A	1084.2	62	No load	0.88 †	17.6
MORGAN STANLEY REAL ESTATE B REFBX	A	Real Estate	C	114.5	5	0.00 **	2.37 †	36.6
MOSAIC EQUITY TRUST INV. MINVX	B	Large-cap Blend	A	157.8	33	No load	0.88	11.5
MUHLKAMP MUHLX	B+	All Cap	A	1758.0	60	No load	1.18	24.5
MUNDER REAL ESTATE EQUITY INV. B MURBX	A	Real Estate	C-	7.7	10	0.00 **	2.23 †	30.9
MUNDER SMALL CAP VALUE Y MCVYX	A	Small-cap Value	B+	246.7	149	0.00 *	1.14	22.4
MUTUAL DISCOVERY Z MDISX	B+	World	A	2483.0	19	No load ‡	1.08	19.4
MUTUAL FINANCIAL SERVICES A TFSIX	A	Financial	B	288.4	14	5.75	1.46 †	15.2
NEEDHAM GROWTH NEEGX	B	Mid-cap Growth	A	283.4	-23	0.00 *	1.77 †	6.2
NEUBERGER BERMAN GENESIS INV. NBGNX	A	Small-cap Value	B	1468.9	16	No load ‡	1.05	18.8
N/I NUMERIC INV. SMALL CAP VALUE NISVX	A	Small-cap Value	A	247.6	25	0.00 * ‡	1.55	23.8
NORTH TRACK PSE TECH 100 INDEX A PPTIX	D	Technology	A	298.4	11	5.25	1.06 †	10.9
OCM GOLD OCMGX	A	Precious Metals	C	80.6	-4	4.50	2.39 †	-13.6
OAKMARK EQUITY & INCOME I OAKBX	B+	Domestic Hybrid	A	7993.8	68	0.00 *	0.92	10.4
OAKMARK GLOBAL I OAKGX	A	World	A	1474.3	45	0.00 * ‡	1.26	15.6
OAKMARK I OAKMX	B+	Large-cap Value	A	6918.0	32	0.00 *	1.05	11.7
OAKMARK INTERNATIONAL I OAKIX	B+	Foreign	A	4445.8	40	0.00 * ‡	1.20	19.1
OAKMARK INTERNATIONAL SMALL CAP I OAKEX	B+	Foreign	A	815.7	48	0.00 * ‡	1.49	28.9
OAKMARK SELECT I OAKLX	B+	Large-cap Value	A	5595.7	2	0.00 * ‡	1.00	9.7
OBERWEIS MICRO CAP OBMGX	B+	Small-cap Growth	A	41.4	-60	0.00 *	1.60 †	2.2
OLD WESTBURY MID CAP EQUITY OWMGX (w)	B	Large-cap Blend	A	841.3	23	No load	1.19 †	9.1
ONE GROUP SMALL CAP VALUE I PSOPX	A	Small-cap Value	B+	855.2	14	No load	0.98	19.5
OPPENHEIMER DEVELOPING MARKETS A ODMAX	B+	Diversified Emerging Markets	A	2149.5	150	5.75 *	1.52 †	33.0
OPPENHEIMER GOLD & SPECIAL MINERALS A OPGSX	A	Precious Metals	C-	268.3	17	5.75 *	1.27 †	-4.3
OPPENHEIMER SMALL CAP VALUE A QVSCX	A	Small-cap Value	C	622.2	76	5.75	1.59 †	28.3
PACIFIC ADVISORS SMALL CAP A PASMIX	A	Small-cap Value	B	16.5	92	5.75 *	4.44 †	36.6
PACIFIC CAPITAL SMALL CAP Y PSCYX	A	Small-cap Value	A	130.4	23	No load	1.29	23.7
PARNASSUS INCOME EQUITY INCOME PRBLX	B	Large-cap Blend	A	849.5	43	No load	0.95	9.3
PERMANENT PRPFX	B+	Domestic Hybrid	A	231.1	127	No load	1.58	12.0
PERRITT MICRO CAP OPPORTUNITIES PRCGX	A	Small-cap Growth	A	229.8	47	0.00 *	1.44	17.1
PHOENIX MID CAP VALUE FUND A FMVX (x)	A	Mid-cap Value	B+	25.6	513	5.75	1.30	24.7
PHOENIX-DUFF & PHELPS REAL ESTATE SECURITIES A PHRAX	A	Real Estate	B	509.9	96	5.75	1.30 †	33.2
PHOENIX-SENECA EQUITY INCOME A REALX (y)	A	Real Estate	F	4.0	23	5.75	2.32 †	29.0
PIMCO NFJ SMALL CAP VALUE A PCVAX	A	Small-cap Value	B	1387.6	43	5.50 * ‡	1.26 †	23.1
PIMCO PEA RENAISSANCE A PQNAX	A	Mid-cap Value	B+	2590.4	57	5.50 *	1.25 †	15.5
PIMCO PEA VALUE A PDLAX	B+	Large-cap Value	A	1137.2	175	5.50 *	1.11 †	17.2
PIONEER OAK RIDGE LARGE CAP GROWTH A ORILX (z)	C	Large-cap Growth	A	37.1	330	4.25	2.00 †	11.4
PIONEER PAPP SMALL & MID CAP GROWTH A PAPPX (aa)	B	Mid-cap Growth	A	39.0	52	5.75	1.25 †	5.5
PIONEER REAL ESTATE SHARES A PWREX	A	Real Estate	D	87.0	48	5.75	1.68 †	35.3
PIONEER RESEARCH A PATMX (ab)	B+	Large-cap Value	A	7.8	-2	5.75	1.40 †	11.4
POLARIS GLOBAL VALUE INVESTOR PGVFX	B+	World	A	125.3	298	0.00 *	1.75	23.6
T. ROWE PRICE CAPITAL APPRECIATION PRWCX	B+	Domestic Hybrid	A	4692.9	72	No load	0.83	15.3
T. ROWE PRICE GROWTH STOCK PRGFY	C	Large-cap Growth	A	7714.0	47	No load	0.76	10.2
T. ROWE PRICE MID CAP GROWTH RPMGX	B	Mid-cap Growth	A	12178.4	28	No load ‡	0.87	18.4
T. ROWE PRICE MID CAP VALUE TRMCX	A	Mid-cap Value	B+	4245.9	155	No load	0.91	20.6
T. ROWE PRICE REAL ESTATE TRREX	A	Real Estate	B+	579.7	114	0.00 *	1.00	36.8
T. ROWE PRICE SMALL CAP VALUE PRSVX	A	Small-cap Value	B+	4354.7	36	0.00 * ‡	0.88	25.6
PRINCIPAL REAL ESTATE SECURITIES A PRRAX (ac)	A	Real Estate	C	66.7	33	5.75 *	1.82 †	33.2
PRUDENT BEAR BEARX	B+	Large-cap Blend	A	377.9	-36	No load	1.83 †	-14.1
PUTNAM NEW VALUE A PANVX	B+	Large-cap Value	A	830.7	27	5.25	1.19 †	15.4
PUTNAM SMALL CAP VALUE A PSLAX	A	Small-cap Value	B	512.1	6	5.25 ‡	1.34 †	25.7
QUANT FOREIGN VALUE ORD. QFVOX	B+	Foreign	A	127.5	70	0.00 **	1.81 †	28.2
RS CONTRARIAN VALUE RSCOX	A	Mid-cap Value	A	533.8	87	No load	1.54 †	29.3
RS GLOBAL NATURAL RESOURCES RSNRX	A	Natural Resources	B+	599.6	641	No load	1.69 †	34.4
RS PARTNERS RSPFX	A	Small-cap Value	A	1983.9	180	No load ‡	1.54 †	31.8
ROYCE LOW PRICED STOCK RYLPX	A	Small-cap Value	C	4735.2	62	0.00 * ‡	1.49 †	13.6
ROYCE MICRO CAP INV. RYOTX	A	Small-cap Value	B	468.5	10	0.00 *	1.48	15.8
ROYCE OPPORTUNITY INV. RYPNX	A	Small-cap Value	B+	1622.2	29	0.00 *	1.15	17.5
ROYCE PENNSYLVANIA MUTUAL INV. PENNX	A	Small-cap Value	B	1195.7	50	0.00 *	0.93	20.2
ROYCE SELECT RYSFX	A	Small-cap Value	B	24.6	8	0.00 *	2.69	19.1
ROYCE SPECIAL EQUITY RYSEX	A	Small-cap Value	B+	847.9	24	0.00 * ‡	1.19	13.9
ROYCE TOTAL RETURN INV. RYTRX	A	Small-cap Value	C	3584.3	40	0.00 *	1.18	17.5
F. RUSSELL REAL ESTATE SECURITIES S RRESX	A	Real Estate	B	1230.8	41	No load	1.18	35.1
RYDEX ARKTOS INV. RYAX	C	Large-cap Growth	A	123.1	-8	No load	1.40	-11.6
RYDEX URSA INV. RYURX (ad)	C	Large-cap Blend	A	319.8	-18	No load	1.38	-9.8

*Includes redemption fee. **Includes deferred sales charge. †12(b)-1 plan in effect. ‡Closed to new investors. ‡‡Available through Oakmark only. NA=Not available.
(w) Formerly Old Westbury Capital Opportunity Fund (x) Formerly FMI Sasco Contrarian Value Fund (y) Formerly Phoenix-Seneca Real Estate Fund A (z) Formerly Oak Ridge Equity Growth A (aa) Formerly Papp Small & Mid Cap Growth Fund (ab) Formerly Pioneer Core Equity Fund A (ac) Formerly Principal Real Estate A (ad) Formerly Rydex Srs.

TOTAL RETURNS (%)				HISTORY	PORTFOLIO DATA						RISK				TELEPHONE	
5 YEARS		10 YEARS		RESULTS VS.	TURNOVER	CASH	UNTAXED	P-E	TOP 10	LARGEST HOLDING	LEVEL	BEST		WORST		
PRETAX	AFTERTAX	PRETAX	AFTERTAX	ALL FUNDS	%	%	GAINS%	RATIO	STKS.%	COMPANY (% ASSETS)		QTR	%RET	QTR	%RET	
17.2	17.2	10.0	9.0	131311	Low	NA	41	26	NA	EnCana (5)	Average	Q4 01	16.6	Q3 01	-16.6	800-637-3863
22.6	21.5	NA	NA	131121	Low	3	29	17	54	Land Securities Group Shares (10)	Low	Q2 03	22.2	Q3 02	-13.2	800-354-8185
8.6	7.1	12.0	10.0	231311	Average	2	4	17	26	France Telecom (4)	Low	Q2 03	18.1	Q3 02	-15.7	800-354-8185
11.9	10.5	11.0	10.0	321111	Low	3	5	19	20	Daibiru (2)	Low	Q2 03	21.4	Q3 02	-14.0	800-354-8185
21.8	19.9	NA	NA	111121	Low	2	18	36	50	Simon Property Group (8)	Very Low	Q4 04	17.6	Q3 02	-10.1	800-354-8185
9.4	9.0	NA	NA	114332	High	3	13	18	36	Sprint Fon Shares (5)	Average	Q2 03	22.6	Q3 02	-23.4	800-354-8185
20.5	19.0	NA	NA	111121	Low	1	40	37	52	Simon Property Group (9)	Very Low	Q4 04	17.5	Q3 02	-10.7	800-869-6397
4.1	3.2	12.0	9.0	223333	Average	8	22	NA	42	Liberty Media New Ser. A (4)	Low	Q2 03	14.8	Q3 02	-16.7	800-368-3195
15.1	14.9	18.0	18.0	113111	Very Low	NA	30	12	40	Countrywide Financial (6)	Average	Q2 03	27.5	Q3 02	-21.5	800-860-3863
19.8	18.3	13.0	11.0	111121	Low	2	41	28	39	Simon Property Group (5)	Very Low	Q4 04	16.1	Q2 04	-7.8	800-468-6337
19.8	19.2	NA	NA	111111	Average	3	27	14	23	iShares Trust (3)	Low	Q2 03	21.9	Q3 02	-20.0	800-468-6337
10.2	8.5	14.0	12.0	221311	Average	4	29	20	18	Berkshire Hathaway Class B (2)	Very Low	Q2 03	15.7	Q3 02	-10.6	800-342-5236
17.0	15.5	NA	NA	111132	Low	7	24	NA	27	Sovereign Bancorp (3)	Very Low	Q3 00	22.1	Q3 02	-11.0	800-342-5236
6.2	5.7	NA	NA	215155	Low	5	8	27	38	Ceradyne Del. (5)	High	Q2 03	23.6	Q3 02	-22.6	800-625-7071
17.7	17.1	17.0	16.0	111131	Low	NA	39	22	30	Church & Dwight (2)	Very Low	Q4 01	15.4	Q3 01	-11.2	800-366-6264
26.6	24.1	NA	NA	111111	Very High	5	14	17	17	Overseas Shipholding Group (1)	Very Low	Q2 03	22.4	Q3 02	-17.0	800-686-3742
-5.2	-6.0	NA	NA	545153	Very Low	0	-29	30	23	IBM C (3)	Very High	Q4 01	32.7	Q3 01	-28.9	800-826-4600
20.7	20.5	7.0	7.0	511115	Low	NA	38	38	53	Newmont Mining (11)	High	Q1 02	39.7	Q2 04	-20.7	800-628-9403
13.5	12.7	NA	NA	111154	High	NA	14	19	NA	US Treasury Notes 8/2011 (5)	Very Low	Q2 03	13.2	Q3 02	-8.6	800-625-6275
18.6	18.2	NA	NA	111112	Low	NA	24	17	NA	Diageo (5)	Low	Q2 03	33.5	Q3 02	-17.7	800-625-6275
9.6	9.4	11.0	10.0	212443	Low	NA	20	17	NA	Washington Mutual (3)	Low	Q2 03	17.0	Q3 02	-16.6	800-625-6275
9.9	9.3	11.0	10.0	221211	Low	NA	25	16	30	Diageo (3)	Average	Q2 03	25.4	Q3 02	-22.9	800-625-6275
13.9	12.9	NA	NA	411111	Low	NA	33	19	NA	Grupo Aeroportuario del Sureste (4)	Low	Q2 03	29.2	Q3 02	-22.3	800-625-6275
14.5	14.1	NA	NA	112444	Low	NA	36	18	NA	Washington Mutual (6)	Low	Q2 03	16.2	Q3 02	-15.6	800-625-6275
15.0	12.8	NA	NA	413115	Average	NA	49	NA	NA	Kensley Nash (5)	High	Q2 03	36.9	Q4 00	-23.4	800-245-7311
3.7	3.5	NA	NA	222554	Low	3	18	24	27	Zimmer Holdings (4)	Low	Q4 03	10.3	Q3 02	-13.7	800-607-2200
19.5	18.3	NA	NA	112211	Average	3	29	18	16	PMI Group (3)	Low	Q4 01	21.3	Q3 02	-21.7	800-338-4345
14.1	13.4	NA	NA	321111	Very Low	8	31	NA	28	Embraer Empresa Brasileira De Aeron (3)	Average	Q2 03	25.9	Q3 01	-23.2	800-525-7048
17.2	16.0	6.0	5.0	411115	High	5	19	36	50	Placer Dome (6)	High	Q1 02	29.3	Q2 04	-15.1	800-525-7048
17.0	16.2	12.0	11.0	111211	Very High	5	22	15	23	Take-Two Interactive Software C (3)	Low	Q2 03	17.0	Q3 02	-15.1	800-525-7048
18.1	17.8	11.0	10.0	215111	Average	NA	43	16	38	Intervoice (6)	Average	Q2 03	37.7	Q3 02	-29.2	800-282-6693
22.9	20.8	NA	NA	111111	High	6	28	21	21	iShares Tr. Russell 2000 Value Index (5)	Low	Q2 03	24.4	Q3 02	-20.0	800-538-4625
7.3	6.0	12.0	10.0	211154	High	14	9	NA	35	Wells Fargo (5)	Very Low	Q4 02	15.9	Q3 02	-12.6	800-999-3505
11.2	10.5	8.0	7.0	211153	Average	15	21	19	54	Gold/U.S. Golden Eagles (10)	Very Low	Q2 03	7.0	Q2 04	-4.6	800-531-5142
22.4	20.5	16.0	14.0	211112	Very Low	7	24	22	17	Flanders (2)	Average	Q1 00	30.8	Q3 02	-18.8	800-332-3133
17.9	17.8	NA	NA	111121	Average	20	-15	14	45	Foot Locker (5)	Low	Q4 03	22.1	Q3 02	-19.9	800-243-4361
23.3	21.7	NA	NA	111121	Low	6	20	30	45	Simon Property Group (7)	Very Low	Q4 04	16.4	Q2 04	-5.8	800-243-4361
19.9	18.4	NA	NA	111121	High	NA	19	31	44	Simon Property Group (7)	Very Low	Q2 03	18.9	Q3 02	-12.2	800-243-4361
18.8	18.1	NA	NA	111131	Low	3	25	15	13	Vintage Petroleum (1)	Very Low	Q2 03	15.3	Q3 02	-11.5	800-426-0107
17.3	16.5	19.0	17.0	114112	Average	0	20	22	35	Navistar International (5)	Average	Q2 03	32.8	Q3 02	-31.8	800-426-0107
13.7	12.7	NA	NA	114112	Average	1	11	17	50	Alcan Aluminum (6)	Average	Q2 03	25.4	Q3 02	-27.9	800-426-0107
0.7	0.4	NA	NA	233333	Average	NA	8	23	33	XTO Energy (4)	Low	Q4 03	9.7	Q3 02	-13.1	800-821-1239
8.3	8.1	NA	NA	123335	Very Low	NA	15	24	30	UCBH Holdings (3)	Average	Q4 01	16.1	Q3 02	-17.2	800-821-1239
21.0	19.3	13.0	11.0	111131	Average	NA	30	32	44	Simon Property Group (7)	Very Low	Q4 04	16.8	Q3 02	-8.8	800-821-1239
10.5	8.3	NA	NA	144443	High	NA	-24	15	32	ExxonMobil (4)	Average	Q4 00	75.3	Q3 02	-16.9	800-821-1239
12.7	12.2	NA	NA	311111	Low	4	18	NA	25	Sovereign Bancorp (2)	Low	Q2 03	24.4	Q3 01	-17.5	888-263-5594
14.4	13.1	14.0	11.0	111142	Low	21	20	19	37	Newmont Mining (2)	Very Low	Q2 03	13.0	Q3 02	-7.9	800-638-5660
0.2	-0.7	12.0	10.0	334344	Low	3	18	21	24	Microsoft (3)	Average	Q2 03	16.4	Q3 02	-15.2	800-638-5660
6.5	6.1	15.0	15.0	223222	Low	5	31	26	17	BJ Services (2)	Average	Q4 01	21.3	Q3 02	-18.9	800-638-5660
16.9	15.8	NA	NA	111121	Average	9	14	23	23	Diamond Offshore Drilling (3)	Low	Q2 03	20.2	Q3 02	-17.3	800-638-5660
22.8	21.1	NA	NA	111121	Very Low	1	27	32	36	Simon Property Group (5)	Very Low	Q4 04	17.2	Q3 02	-7.8	800-638-5660
19.7	18.8	16.0	14.0	111121	Very Low	7	42	19	18	Landstar Systems(2)	Very Low	Q2 03	17.6	Q3 02	-17.1	800-638-5660
22.4	20.7	NA	NA	111121	Average	2	29	31	42	Boston Properties (6)	Very Low	Q4 04	17.1	Q2 04	-7.4	800-247-4123
11.9	10.7	NA	NA	111155	Very High	184	-42	NA	180	Cardero Resource #1 (3)	Average	Q3 01	41.5	Q4 01	-22.1	800-711-1848
10.2	9.8	NA	NA	111232	Average	1	19	19	33	Citigroup (4)	Low	Q2 03	21.0	Q3 02	-19.1	800-225-1581
17.9	17.4	NA	NA	113111	Low	1	37	19	12	Fleetwood Enterprises (1)	Low	Q2 03	24.5	Q3 02	-22.2	800-225-1581
11.2	11.1	NA	NA	421111	Average	10	26	13	29	Continental AG (4)	Average	Q2 03	22.6	Q3 01	-18.1	800-326-2151
17.1	17.1	8.0	8.0	231111	High	16	6	18	45	UnitedGlobalCom Class A (4)	Low	Q4 04	17.4	Q3 01	-19.0	800-766-3863
23.1	23.0	NA	NA	121121	Average	16	14	18	48	Alcoa (4)	Low	Q4 03	22.0	Q3 01	-15.2	800-766-3863
27.7	27.0	NA	NA	111111	High	15	22	20	37	West Fraser Timber (3)	Low	Q2 03	25.0	Q3 01	-14.9	800-766-3863
16.3	15.8	17.0	16.0	112113	Average	11	19	23	30	Meridian Gold (2)	Average	Q4 01	27.7	Q3 02	-21.3	800-221-4268
17.1	15.9	15.0	14.0	112112	Average	6	30	26	22	Trican Well Services (2)	Low	Q2 03	27.8	Q3 02	-23.5	800-221-4268
18.8	17.8	NA	NA	113112	Average	7	27	25	18	Hexcel New (1)	Average	Q2 03	31.9	Q3 02	-27.8	800-221-4268
16.5	14.7	14.0	12.0	111121	Low	10	31	19	24	Unit (1)	Low	Q2 03	19.9	Q3 02	-17.4	800-221-4268
16.4	15.0	NA	NA	111211	Low	8	38	26	34	Input/Output (4)	Average	Q4 01	26.7	Q3 02	-19.9	800-221-4268
20.6	20.2	NA	NA	111143	Low	13	31	15	36	Borders Group (4)	Very Low	Q4 01	20.9	Q3 02	-9.0	800-221-4268
15.6	14.6	15.0	14.0	111132	Low	7	28	18	19	Canadian Gov. 4.25% 9/1/08 (2)	Very Low	Q2 03	16.0	Q3 01	-12.6	800-221-4268
21.7	19.7	15.0	12.0	111121	Average	4	38	26	41	Simon Property Group Bond (7)	Very Low	Q4 04	16.9	Q3 02	-8.6	800-426-7969
1.4	1.1	NA	NA	111155	Very Low	100	-68	NA	100	NA	Very High	Q3 01	51.3	Q4 01	-28.9	800-820-0888
2.8	2.5	-7.0	-7.0	111155	Very Low	100	-56	NA	92	NA	Average	Q3 01	17.7	Q2 03	-13.8	800-820-0888

Data: Standard & Poor's

Personal Business Mutual Funds

FUND/SYMBOL	OVERALL RATING (COMPARES RISK-ADJUSTED PERFORMANCE OF EACH FUND AGAINST ALL FUNDS)	CATEGORY	RATING (COMPARES RISK-ADJUSTED PERFORMANCE OF FUND WITHIN CATEGORY)	SIZE ASSETS \$MIL.	% CHG. 2003-2004	FEES SALES CHARGE (%)	EXPENSE RATIO (%)	2004 RE- PRE- TAX
STI CLASSIC SMALL CAP VALUE EQUITY L STCEX	A	Small-cap Value	B	47.0	4	0.00 **	2.26 †	24.8
SCHRODER CAPITAL U.S. OPPORTUNITIES INV. SCUIX	B+	Small-cap Growth	A	90.0	82	No load	1.93	25.3
SCUDDER DREMAN HIGH RETURN A KDHAX	B+	Large-cap Value	A	4171.7	40	5.75	1.27 †	13.5
SCUDDER GOLD & PRECIOUS METALS S SCGDY	A	Precious Metals	A	254.5	-12	No load	1.64	-8.9
SCUDDER SMALL COMPANY VALUE S SCSUX	A	Small-cap Value	C	340.8	23	0.00 *	1.16	23.4
SECURITY CAPITAL U.S. REAL ESTATE S SUSIX (ae)	A	Real Estate	B	343.5	19	No load	1.28 †	36.8
SECURITY MID CAP VALUE A SEVAX	A	Mid-cap Value	B+	217.8	48	5.75 *	1.65 †	26.8
SELIGMAN SMALL CAP VALUE A SSCVX	A	Small-cap Value	C	156.2	48	4.75	1.81 †	20.6
SEQUOIA SEQUX	B+	Large-cap Value	A	3803.0	-4	No load †	1.00	4.7
SKYLINE SPECIAL EQUITIES SKSEX	A	Small-cap Value	B	556.5	9	No load	1.48	16.6
SMITH BARNEY SECURITY & GROWTH A SAFEX	B+	Domestic Hybrid	A	83.3	-3	No load †	1.00 †	7.9
SMITH BARNEY SMALL CAP VALUE A SBVAX	A	Small-cap Value	B	234.5	102	5.00	1.19 †	20.8
SPIRIT OF AMERICA REAL ESTATE A SOAAX	A	Real Estate	C-	184.7	30	5.25	1.97 †	24.0
STATE STREET RESEARCH AURORA A SSRAX	A	Small-cap Value	C	2334.2	19	5.75 †	1.55 †	14.9
STATE STREET RESEARCH GLOBAL RESOURCES A SSGRX	A	Natural Resources	A	525.0	225	5.75	1.34 †	47.6
STATE STREET RESEARCH HEALTH SCIENCE A SHSAX	A	Health	B+	73.2	140	5.75	1.55 †	14.6
STOCKCAR STOCKS INDEX SCARX (af)	B	Large-cap Blend	A	5.8	11	No load	1.50 †	17.4
STRATEGIC PARTNERS REAL ESTATE SECURITIES B PURBX	A	Real Estate	B	37.0	18	0.00 **	2.33 †	38.7
STRATTON MONTHLY DIVIDEND REIT STMDX	A	Real Estate	C	208.0	6	0.00 *	1.00	22.2
STRATTON SMALL CAP VALUE STSCX	A	Small-cap Value	B	100.6	69	0.00 *	1.67	26.4
STRONG ADVISOR SMALL CAP VALUE Z SSMVX	A	Small-cap Value	B+	1323.2	19	No load †	1.40	20.1
STRONG LARGE COMPANY GROWTH INV. SLGIX	C	Large-cap Growth	A	85.8	8	No load	1.50 †	17.5
STRONG MID CAP DISCIPLINED SMCDX	A	Mid-cap Value	B+	715.9	136	No load	1.50	21.2
TAMARACK ENTERPRISE S TETSX (ag)	A	Small-cap Value	B+	363.4	30	0.00 *	1.08	15.2
TAMARACK MICRO CAP VALUE S TMVXS (ah)	A	Small-cap Value	B	234.9	80	0.00 * †	1.03	23.7
TCW GALILEO DIVIDEND FOCUSED N TGIGX	A	Large-cap Value	A	269.7	729	No load	1.39 †	17.4
TCW GALILEO OPPORTUNITY N TGOX	A	Small-cap Value	C	39.8	63	No load	1.50 †	13.6
TCW GALILEO VALUE OPPORTUNITIES I TGVOX	A	Mid-cap Value	A	881.6	45	No load	0.98	10.7
TEMPLETON FOREIGN SMALL COMPANIES A FINEX	B	Foreign	A	515.3	41	5.75	1.52 †	19.8
TEXAS CAPITAL VALUE & GROWTH TCVGX	A	All Cap	A	44.6	38	5.75 *	1.93 †	17.6
THIRD AVENUE REAL ESTATE VALUE TAREX	A	Real Estate	B+	1871.1	161	0.00 *	1.19	28.2
THIRD MILLENNIUM RUSSIA TMRFX	A	Diversified Emerging Markets	A	51.6	109	0.00 **	2.75 †	20.3
THOMPSON PLUMB GROWTH THPGX	B+	Large-cap Blend	A	1485.9	70	No load	1.07	4.2
TOCQUEVILLE GOLD TGLDX	A	Precious Metals	B+	570.9	9	0.00 *	1.68 †	-5.8
TRANSAMERICA PREMIER CORE EQUITY INV. TPVIX	B	Large-cap Blend	A	65.6	324	No load	1.20 †	13.8
TURNER MICRO CAP GROWTH TMCGX	A	Small-cap Blend	B+	410.3	37	No load †	1.40	23.2
UMB SCOUT SMALL CAP UMBHX	A	Small-cap Value	C	171.1	200	0.00 *	0.89	24.7
U.S. GLOBAL ACCOLADE EASTERN EUROPEAN EUROX	A	Europe	A	384.3	566	No load	2.90 †	52.4
U.S. GLOBAL INV. GLOBAL RESOURCES PSPFX	A	Natural Resources	B+	266.1	108	0.00 *	1.54	30.4
U.S. GLOBAL INV. GOLD SHARES USERX	A	Precious Metals	C	86.7	-2	0.00 *	1.93	-6.4
U.S. GLOBAL INV. WORLD PRECIOUS MINERALS UNWPX	A	Precious Metals	C	339.6	6	0.00 *	1.47	1.0
USAA PRECIOUS METALS & MINERALS USAGX	A	Precious Metals	B+	349.2	2	No load	1.26	-10.8
UNDISCOVERED MANAGERS BEHAVIORAL VALUE INSTL UBVLX	A	Small-cap Value	C	77.2	76	No load	1.40	20.8
UNDISCOVERED MANAGERS REIT INSTL URTLX	A	Real Estate	B+	190.8	-2	No load	1.17	32.4
VALLEY FORGE VAFGX	B+	Domestic Hybrid	A	11.0	24	No load	1.32	5.4
VAN ECK INTERNATIONAL INVESTORS GOLD A INIVX	A	Precious Metals	C	282.3	-11	5.75	1.85 †	-7.7
VAN KAMPEN EXCHANGE ACEHX	C	Large-cap Growth	A	62.3	-1	No load †	0.78	5.3
VAN KAMPEN GLOBAL FRANCHISE A VGFX	B+	World	A	1163.0	132	5.75 *	1.51 †	13.0
VAN KAMPEN REAL ESTATE SECURITIES A ACREX	A	Real Estate	D	331.7	27	4.75	1.55 †	36.7
VANGUARD CAPITAL OPPORTUNITY VHCX	B	Mid-cap Growth	A	6766.9	28	0.00 * †	0.59	21.6
VANGUARD ENERGY INV. VGENX	A	Natural Resources	B+	4766.4	148	0.00 * †	0.38	36.6
VANGUARD GLOBAL EQUITY VHGX	B+	World	A	1143.3	54	No load	1.05	20.1
VANGUARD PRIMECAP VPMCX	C	Large-cap Growth	A	22226.0	22	0.00 * †	0.46	18.3
VANGUARD PRECIOUS METALS VGPMX	A	Precious Metals	B	885.4	30	0.00 *	0.55	8.1
VANGUARD REIT INDEX VGSIX	A	Real Estate	C	4380.9	52	0.00 *	0.24	30.7
VANGUARD WELLESLEY INCOME INV. VWINX	B+	Domestic Hybrid	A	9087.2	11	No load	0.26	7.6
VANGUARD WELLINGTON INV. VWELX	B	Domestic Hybrid	A	27503.0	19	No load	0.36	11.2
VANTAGEPOINT EQUITY INCOME VPEIX	B+	Large-cap Value	A	1041.0	35	No load	0.92	14.8
VICTORY REAL ESTATE A VREIX	A	Real Estate	F	22.5	-20	5.75	1.40	28.8
WM EQUITY INCOME A CMPBX	B+	Large-cap Value	A	480.0	74	5.50	0.95 †	18.7
WP STEWART & CO. GROWTH WPSGX	C	Large-cap Growth	A	80.8	10	No load	1.99	17.7
WALDEN SOCIAL EQUITY WSEFX	B	Large-cap Blend	A	44.7	20	No load	1.00	10.8
WASATCH CORE GROWTH WGROX	A	Small-cap Blend	A	1631.7	13	0.00 * †	1.21	21.6
WASATCH MICRO CAP WMICX	A	Small-cap Growth	A	546.6	-3	0.00 * †	2.19	12.7
WASATCH SMALL CAP VALUE WMCVX	A	Small-cap Value	A	777.8	8	0.00 * †	1.73	21.6
WELLS FARGO SMALL CAP OPPORTUNITIES I NVSOX	A	Small-cap Growth	A	628.4	44	No load	1.20	25.8
WELLS S&P REIT INDEX A WSPAX	A	Real Estate	C-	204.0	27	4.00	0.99 †	30.1
WILLIAM BLAIR SMALL CAP GROWTH N WBSNX	A	Small-cap Growth	A	433.5	74	0.00 *	1.55 †	27.3
WILSHIRE TARGET SMALL COMPANY VALUE INV. DTSVX	A	Small-cap Value	C	36.2	196	No load	1.52 †	22.8
WOMENS EQUITY FEMMX	B	Large-cap Blend	A	27.9	51	No load	1.50 †	10.7
YACKTMAN YACKX	A	All Cap	A	346.6	17	No load	0.94	9.9
YACKTMAN FOCUSED YAFFX	A	All Cap	A	86.6	-25	No load	1.26	10.0

*Includes redemption fee. **Includes deferred sales charge. †12(b)-1 plan in effect. ‡Closed to new investors. NA=Not available.

(ae) Formerly Security Capital U.S. Real Estate Shares (af) Formerly Conesco Stock Car Stocks Index (ag) Formerly Babson Enterprise Fund (ah) Formerly Babson Shadow Stock F

TOTAL RETURNS (%)				HISTORY	PORTFOLIO DATA						RISK				TELEPHONE	
5 YEARS		10 YEARS		RESULTS VS. ALL FUNDS	TURNOVER	CASH %	UNTAXED GAINS%	P-E RATIO	TOP 10 STKS. %	LARGEST HOLDING COMPANY (% ASSETS)	LEVEL	BEST		WORST		
PRETAX	AFTERTAX	PRETAX	AFTERTAX									QTR	% RET	QTR	% RET	
18.1	17.8	NA	NA	111121	Average	0	11	18	28	Autodesk (4)	Very Low	Q2 03	16.7	Q3 02	-12.8	800-428-6970
15.3	13.6	17.0	14.0	111321	High	NA	16	15	21	SEI Daily Income Trust (5)	Low	Q1 00	18.1	Q3 02	-17.4	800-464-3108
11.7	11.1	15.0	14.0	123333	Low	9	18	13	52	Altria Group (8)	Low	Q3 00	22.8	Q3 02	-17.6	800-621-1048
25.7	24.9	9.0	7.0	411115	Average	6	17	NA	47	Placer Dome - Canada (8)	High	Q3 03	44.3	Q2 04	-18.9	800-621-1048
15.4	14.4	NA	NA	211121	Very High	3	20	17	17	Energen (2)	Low	Q2 03	18.1	Q3 02	-21.1	800-621-1048
21.7	19.7	NA	NA	111121	Low	NA	35	41	56	Macerich (7)	Very Low	Q4 04	17.2	Q3 02	-9.6	800-409-4189
18.2	17.5	NA	NA	112111	Average	6	42	3	28	KFX (5)	Low	Q2 03	27.2	Q3 02	-22.5	800-888-2461
16.9	16.8	NA	NA	111311	Low	NA	27	NA	NA	Korn/Ferry International (4)	Low	Q2 03	25.1	Q3 02	-20.8	800-624-7378
9.6	8.5	16.0	14.0	111155	Very Low	9	68	NA	95	Berkshire Hathaway Class A (38)	Very Low	Q3 00	13.6	Q1 03	-7.4	800-686-6884
16.6	16.0	13.0	11.0	111122	Average	2	27	14	21	Airgas (3)	Low	Q2 03	21.9	Q3 02	-20.9	800-828-2759
11.9	9.3	NA	NA	111234	Average	47	16	25	64	Todco (3)	Low	Q1 00	19.5	Q3 02	-12.9	800-451-2010
18.5	17.6	NA	NA	111121	High	5	29	20	18	Steiner Leisure Shares (2)	Low	Q4 01	19.4	Q3 02	-15.8	800-451-2010
21.6	19.3	NA	NA	111131	Very Low	NA	33	40	42	Pennsylvania Real Estate Inv. Tr. (5)	Very Low	Q2 01	14.4	Q2 04	-8.4	800-452-4892
17.0	16.3	NA	NA	111312	Average	4	29	28	11	Wabtec (1)	Low	Q4 01	22.0	Q3 02	-23.8	800-531-0131
34.7	34.5	19.0	18.0	121111	Average	3	37	19	40	Peabody Energy (5)	Average	Q2 00	27.2	Q3 01	-17.0	800-531-0131
18.8	18.1	NA	NA	114112	Average	4	13	38	31	Novartis AG Sponsored ADR (6)	Average	Q2 03	34.7	Q2 02	-15.2	800-531-0131
7.4	6.2	NA	NA	313442	Average	NA	NA	20	28	RC2 (4)	Low	Q4 01	17.2	Q3 02	-15.3	800-494-2755
21.8	21.0	NA	NA	111111	Average	0	18	30	60	Simon Property Group (8)	Very Low	Q4 04	17.5	Q3 02	-8.0	800-225-1852
20.5	17.8	12.0	9.0	111131	Average	NA	25	38	33	Nationwide Health Properties (3)	Very Low	Q2 03	13.1	Q2 04	-7.4	800-472-4266
18.7	18.1	15.0	14.0	111111	Low	NA	39	16	29	Hovnanian Enterprises Class A (4)	Low	Q2 03	21.3	Q3 02	-14.5	800-472-4266
20.1	19.6	NA	NA	111111	Low	6	33	23	26	Range Resources (3)	Low	Q2 03	22.5	Q3 01	-17.7	800-368-3863
2.6	1.6	NA	NA	233442	Very High	2	11	25	36	Tyco International (5)	Average	Q2 03	13.5	Q2 02	-13.2	800-368-3863
15.7	14.8	NA	NA	111221	Very High	20	15	19	45	TXU (3)	Low	Q4 01	23.9	Q3 02	-16.9	800-368-3863
19.5	18.8	14.0	12.0	211112	Low	7	32	20	27	Tetra Technologies (3)	Low	Q2 03	18.8	Q3 02	-20.2	800-422-2766
17.3	16.3	15.0	14.0	212111	Very Low	2	28	18	12	Meritage Homes (1)	Low	Q2 03	25.5	Q3 02	-21.1	800-422-2766
15.6	14.1	14.0	11.0	121332	Average	8	9	16	35	Microsoft (3)	Very Low	Q3 00	16.8	Q3 02	-14.6	800-386-3829
16.2	15.5	12.0	11.0	111313	Average	7	23	32	26	Eclipsys (4)	Low	Q2 03	23.8	Q3 02	-19.7	800-386-3829
17.3	16.7	NA	NA	111513	Average	2	15	21	26	McAfee (3)	Average	Q4 01	30.1	Q3 02	-25.7	800-386-3829
8.9	8.2	9.0	8.0	331111	Very Low	9	30	NA	24	Giordano International Shares (2)	Low	Q2 03	22.8	Q3 02	-17.9	800-342-5236
18.5	18.5	NA	NA	111312	Very High	NA	81	12	18	Centurytel (2)	Low	Q2 03	35.4	Q3 02	-19.0	800-880-0324
23.2	22.4	NA	NA	111121	Very Low	NA	23	22	63	St. Joe (9)	Very Low	Q2 03	15.2	Q3 02	-6.5	800-443-1021
21.3	18.9	NA	NA	511111	Average	NA	14	NA	49	Severstal Jt. Stk. Co. Sponsored GDR R (8)	High	Q1 02	32.3	Q2 00	-33.0	800-527-9525
10.4	8.9	16.0	15.0	111335	Average	0	9	13	48	Fannie Mae (8)	Average	Q2 03	23.8	Q3 02	-18.9	800-999-0887
23.6	23.1	NA	NA	411115	Average	6	24	35	48	Gold Coin (9)	High	Q1 02	45.9	Q2 04	-17.0	800-697-3863
3.1	2.9	NA	NA	233443	Average	NA	11	29	29	PLC Systems (4)	Average	Q1 00	16.2	Q3 01	-18.5	800-892-7587
15.8	14.7	NA	NA	111311	High	10	26	13	25	Petroleum Dev. (2)	High	Q1 00	25.2	Q3 02	-20.3	800-224-6312
15.6	14.3	12.0	11.0	112211	High	7	15	23	39	iShares Tr. Russell 2000 Growth Ind. (5)	Very Low	Q4 03	15.5	Q3 02	-14.7	800-996-2862
25.4	25.1	NA	NA	511111	Average	8	15	NA	55	Cez A.S. Praha Shares (8)	Average	Q1 04	25.3	Q2 00	-24.9	800-873-8637
24.0	23.5	11.0	10.0	241111	High	13	20	NA	31	Northern Orion Resources (3)	Average	Q4 03	35.9	Q3 02	-20.1	800-873-8637
17.2	17.2	-10.0	-10.0	511115	High	9	-111	NA	45	Northern Orion Resources (7)	Very High	Q1 02	52.4	Q2 04	-20.8	800-873-8637
18.9	18.1	3.0	3.0	511115	Average	7	18	NA	39	Northern Orion Resources (6)	High	Q1 02	49.7	Q2 04	-22.1	800-873-8637
23.3	22.7	7.0	6.0	411115	Average	5	23	NA	46	Newcrest Mining NPV (7)	High	Q1 02	38.9	Q2 04	-16.6	800-531-8181
15.7	15.0	NA	NA	212111	Average	11	25	33	26	General Cable (3)	Average	Q2 03	36.2	Q3 02	-23.5	800-348-4782
22.3	20.2	NA	NA	111121	High	0	25	37	45	Simon Property Group (7)	Very Low	Q4 04	13.8	Q3 02	-7.5	800-348-4782
7.9	6.6	6.0	4.0	311145	Low	NA	-1	24	61	Commerce Bancorp N.J. (18)	Low	Q4 03	14.1	Q3 02	-15.0	800-548-1942
19.0	17.6	0.0	-1.0	511115	Very High	0	50	NA	51	Glamis Gold (8)	High	Q1 02	45.2	Q2 04	-18.5	800-221-2220
0.3	0.1	12.0	12.0	224445	Very Low	1	97	20	65	Intel (10)	Average	Q1 00	19.5	Q3 02	-17.7	800-421-5666
14.3	13.8	NA	NA	121443	Very Low	8	18	17	51	Brit. Amer. Tobacco (8)	Very Low	Q2 03	16.0	Q3 02	-8.2	800-421-5666
20.8	19.6	15.0	13.0	111211	Low	2	39	37	51	Simon Property Group (8)	Very Low	Q4 04	17.0	Q3 02	-10.5	800-421-5666
6.9	6.5	NA	NA	135511	Very Low	6	14	33	33	Biogen IDEC (5)	High	Q1 00	30.9	Q3 01	-23.9	800-662-2739
19.3	17.9	16.0	14.0	121331	Low	8	33	15	38	ABN Triparty Mortgage (4)	Low	Q4 03	16.7	Q3 02	-13.8	800-662-2739
9.5	8.5	NA	NA	321111	Low	5	12	22	15	Costco Wholesale New (1)	Low	Q2 03	18.9	Q3 02	-18.8	800-662-2739
2.2	1.7	15.0	14.0	244222	Very Low	10	32	29	39	Biogen IDEC (5)	Average	Q1 00	19.5	Q3 01	-21.7	800-662-2739
20.3	18.8	6.0	5.0	411114	Low	2	29	20	62	Impala Platinum Hldgs. ADR (11)	High	Q1 02	25.9	Q1 00	-19.2	800-662-2739
21.2	19.0	NA	NA	111121	Very Low	2	30	31	33	Equity Office Properties Trust (5)	Very Low	Q4 04	15.0	Q3 02	-8.5	800-662-2739
9.0	7.2	10.0	8.0	111154	Average	1	11	15	14	ExxonMobil (2)	Very Low	Q2 03	8.0	Q3 02	-3.9	800-662-2739
7.5	6.0	12.0	10.0	211153	Average	3	20	18	15	U.S. Treasury Notes 08/31/2005 (3)	Very Low	Q2 03	12.6	Q3 02	-11.0	800-662-2739
9.5	8.4	NA	NA	112332	Low	18	16	14	33	Hilton Hotels (2)	Low	Q2 03	18.9	Q3 02	-16.3	800-669-7400
19.0	17.5	NA	NA	111131	High	5	37	35	33	Equity Office Properties Trust (4)	Very Low	Q4 04	13.9	Q3 02	-8.1	800-539-3863
10.5	9.2	12.0	10.0	112331	Low	7	33	15	24	Harrahs Entertainment (2)	Very Low	Q2 03	15.7	Q3 02	-14.8	800-222-5852
-0.5	-0.8	11.0	10.0	343542	Low	1	22	26	56	Target (7)	Average	Q4 04	15.1	Q3 02	-12.7	888-695-4092
3.6	3.5	NA	NA	222443	Average	2	16	19	22	BP Amoco ADR (3)	Low	Q2 03	12.9	Q3 02	-12.5	800-282-8782
18.1	17.3	19.0	18.0	114221	Average	3	27	15	29	Fidelity National Financial (4)	Average	Q2 01	30.7	Q3 02	-26.4	800-551-1700
24.5	21.4	NA	NA	112113	Low	2	30	26	24	Amsurg (4)	Average	Q4 01	30.1	Q3 02	-19.3	800-551-1700
22.1	21.0	NA	NA	112111	Average	1	28	16	23	Global Imaging Systems (3)	Low	Q2 03	25.9	Q3 02	-28.0	800-551-1700
15.6	14.2	NA	NA	111321	Average	6	18	21	21	Reinsurance Group of America (2)	Low	Q1 00	18.4	Q3 02	-17.4	800-222-8222
20.8	18.4	NA	NA	111131	Very Low	4	24	32	35	Simon Property Group (5)	Very Low	Q4 04	14.5	Q3 02	-9.0	800-282-1581
23.5	23.0	NA	NA	111311	Average	NA										

Data: Standard & Poor's



BY ROBERT BARKER

Marriott Stock: Should You Check In?

Note to self: Before dying, visit Via Privata Fratelli Gabba 7/b, Milan, Italy. This is the new Bulgari Hotel Milano, with rooms that start at \$600 a night and a pool that jeweler Bulgari has lined in gold mosaic. Despite my usual stinginess, one long swim in that pool beckons to me as a worthwhile delight.

Credit the hotel's manager and part-owner, Marriott International, with getting a cheapskate like me to dream about the Bulgari. The world's No. 1 hotelier is at the top of its game, with hotel brands ranging from Bulgari and Ritz-Carlton to the flagship Marriotts and its Renaissance Hotels to limited-service SpringHill Suites and Fairfield Inns. On Feb. 8, Marriott is due to unveil 2004 results, and Wall Street expects it will report that revenues grew 11%, to \$10 billion, and profits leaped 25%, to \$2.43 or so a share. The stock recently neared 64, up by more than half from 2004 lows.

In part, the stock is only bouncing back from a depression brought on by war, tepid economic growth, and fears of terrorism. So why am I so unenthusiastic about the shares now? Not because there's anything wrong with the company's strategy that aims to produce as much cash as possible while minimizing the amount of capital tied up in hotels and timeshare resorts. It's simply a matter of a) price, and b) watching what those who know more than I know are doing.

ON THE FIRST SCORE, Marriott today commands a premium among the big three hotel chains (table). Its enterprise value—that is, stock market capitalization plus net debt—comes to more than 16 times estimates of last year's earnings before interest, taxes, depreciation, and amortization. That's well above those of its two leading stock-market rivals. Meantime, its earnings growth is widely expected to slow sharply this year, to perhaps 17%, from last year's 25%.

In other words, for all of its operating power, Marriott has become unattractive to investors who heed the prices they pay. A case in point is Southeastern Asset Management. This Memphis firm is a noted buyer, and patient holder, of deep-value stocks. This time a year ago, it owned more than 7% of Marriott. It dumped most of that last summer "when the stock approached our appraisal," Southeastern told its clients in a recent report. "The sale was bittersweet. The company had been a core holding for a number of years, and it is extremely difficult to replace companies that consistently

ULTRALUXE At the Bulgari, rooms start at \$600



Premium Priced at Marriott

COMPANY/SYMBOL	ENTERPRISE VALUE (MILLIONS)	EBITDA* (MILLIONS)	EV
Hilton Hotels HLT	\$12,169	\$1,008	
Marriott International MAR	16,059	998	
Starwood Hotels & Resorts Worldwide HOT	16,656	1,147	

*Earnings before interest, taxes, depreciation and amortization 2004 estimates
Data: Company reports, Reuters Fundamentals estimates

grow value." By yearend, Southeastern had sold the last Marriott. A Marriott spokeswoman told me she expects investors such as Southeastern to buy the stock again.

Then, there are the insiders, who have been trimming too. Because the Marriott family, led by Chief Executive "Bill" Marriott Jr., controls many chunks of stock via a of trusts, its recent sales can be dismissed as driven by financial planning concerns as diversification. But many insiders also have been selling, notably veteran Chief Financial Officer Arne Sorenson. He sold 21,668 shares Dec. 20, which happened to be the day Marriott peaked at 63.99. He received average proceeds of 63.40 a share, for a total of nearly \$1.4 million. The prior December, he sold 63.99.

Perhaps the insiders' sales were part of a prearranged diversification plan? Marriott's spokeswoman said that not the case, but noted that the execs have most of their worth in the stock, so selling some is expectably prudent. Naturally, there's no reason successful execs shouldn't take some of the stock they earn for cash. There's also no reason the cash they get should be yours. ■

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BY GENE G. MARCIAL

SACRAMENTO LAND MAY HAVE SUITORS BIDDING FOR **GENCORP**

SPECTRUM IS POISED TO MARKET A GENERIC MIGRAINE REMEDY

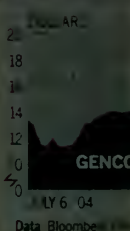
A REV-UP IN TRUCKING COULD INFLATE **BANDAG'S** RETREADS

GenCorp's Earthly Assets

GENCORP (GY), WHOSE AEROJET UNIT'S ROCKET hardware has flown on every U.S. mission to Mars, is catching the eye of investors for its valuable hidden assets: land. The company owns 12,680 acres of undeveloped property in Sacramento. In addition, several of its big shareholders, led by mutual-fund mogul Mario Gabelli, who owns 12.5%, and Steel Partners, with 7.5%, are convinced that GenCorp is buyout bait. In fact, Steel Partners tried to purchase the company in November at 17 a share, where the stock stands now—up from 11 in August. But the board rejected the bid. Gabelli figures GenCorp is worth even more—in excess of 25 a share, based on its real estate and its business of making propulsion and electronic surveillance systems for the aerospace and defense industries. He expects that a new bidder with real estate interests could make a new buyout offer. David

Lorber of Pirate Capital, which owns 2.3%, says GenCorp is a “sum of the parts” asset play. It will continue to operate and expand its core space-propulsion business, which he says is worth \$560 million, and develop and sell its land: It's the largest contiguous plot in Sacramento—roughly the size of Manhattan. Now in the entitlement process are 5,800 acres, which, once approved for development, would be worth \$1.15 billion, or \$18.50 a share, says Lorber. The rest, expected to be entitled in the next years, has a current value, he says, of \$344 million, or \$5 a share. Joseph Nadol of J.P. Morgan Securities, who rates stock “outperform,” sees earnings of 10¢ a share in fiscal ended Nov. 30, and 26¢ in 2006 vs. a loss in 2004. GenCorp declined comment on whether it has received new offer

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ing Spectrum's Headaches?

NY SPECTRUM PHARMACEUTICALS (SPPI), which has yet to make a dime, looks set to take on Big Pharma. So says Reni Benjamin of Rodman & W, which has done banking for um. He rates the stock, now at outperform/speculative risk," 12-month target of 12. Spectrum t Food & Drug Administration al, he says, for the first generic of Imitrex, a migraine drug ed by GlaxoSmithKline, whose expires in mid-2007. On Jan. 10, A accepted Spectrum's applica- clear the drug. "Since it is the file for an 'abbreviated new drug application' for the , Spectrum could enjoy, once O.K.'d, a six-month period sive marketing of the drug," notes Benjamin. Imitrex 04 sales of \$200 million. Spectrum CEO Rajesh Shrotriya spectrum could initially capture 20% of the market. Glaxo, , could either go the difficult route of seeking a patent on—or let Spectrum market Imitrex and the generic.



Bandag May Be Laying Rubber

BANDAG (BDG), THE WORLD'S largest retreader of truck and bus tires, is bouncing back after hitting a few speed bumps last year. The rising cost of raw materials, especially oil, and the loss in May of a big

contract with Roadway Express after it merged with Yellow Freight, took its toll on earnings. The stock slid from 51 on Apr. 5 to a low of 39 on May 10. It has since rebounded to 47. Most analysts, however, remain unenthusiastic about the stock. But not Steven M. Cohen, chief investment officer at Kellner DiLeo Cohen, which owns shares. "There was an overreaction to the Roadway loss," he says. Trucking activity has been robust as the economy continues to recover, notes Cohen. Bandag's February purchase of Speedco from Royal Dutch/Shell gave it a new driver to speed up sales, he says. Speedco provides truckers with quick lubrication services nationwide, plus a new distribution channel for its tires, which, Cohen says, gives Bandag a big opportunity to boost retread-tire sales. Since its purchase, Speedco pulled in \$38.1 million in revenues through Sept. 30. Cohen figures Bandag, trading at 12 times estimated 2005 earnings of \$3.91 a share, deserves a price-earnings ratio of 16, implying a share price of 62. The consensus estimate for 2006 is \$4.35, up from an estimated \$2.94 in 2004 and \$3.11 in 2003, according to Zacks Investment Research. ■



BusinessWeek online

Gene Marcial's Inside Wall Street is posted at businessweek.com/today.htm at 5 p.m. EST on the magazine's publication day, usually Thursdays.

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STOCKS



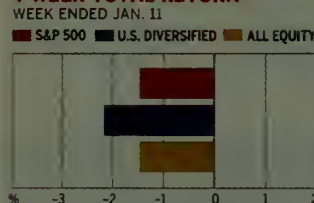
COMMENTARY

After bouncing around most of the week, markets got a boost on news that Intel earnings and sales beat expectations. Looking ahead, the chipmaker said tech spending is picking up. Apple Computer also added some shine, announcing it will offer consumers low-cost Macs. For the week, the Dow, the NASDAQ Composite, and S&P 500 all finished in positive territory.

Data: Bloomberg Financial Markets, Reuters

MUTUAL FUNDS

4-WEEK TOTAL RETURN



52-WEEK TOTAL RETURN



Data: Standard & Poor's

U.S. MARKETS

	JAN. 12	WEEK	% CHANGE YEAR TO DATE	LAST 12 MONTHS
S&P 500	1187.7	0.3	-2.0	5.4
Dow Jones Industrials	10,617.8	0.2	-1.5	1.3
NASDAQ Composite	2092.5	0.1	-3.8	-0.9
S&P MidCap 400	636.1	0.2	-4.1	8.2
S&P SmallCap 600	311.3	-0.3	-5.3	12.3
DJ Wilshire 5000	11,642.7	0.3	-2.6	5.9

SECTORS

BusinessWeek 50*	699.5	1.5	12.4	13.3
BW Info Tech 100**	361.2	-0.1	3.0	-2.0
S&P/BARRA Growth	573.3	0.7	-1.5	1.7
S&P/BARRA Value	610.0	-0.1	-2.5	9.1
S&P Energy	285.3	3.1	-1.2	26.7
S&P Financials	402.3	-0.6	-2.1	5.1
S&P REIT	133.7	-1.3	-7.5	15.5
S&P Transportation	225.6	-4.0	-6.6	14.6
S&P Utilities	138.2	0.5	-2.4	17.1
GST Internet	167.1	-0.2	-6.3	9.5
PSE Technology	741.2	-0.8	-4.9	0.9

*Mar. 19, 1999=1000 **Feb. 7, 2000=1000

GLOBAL MARKETS

	JAN. 12	WEEK	% CHANGE YEAR TO DATE
S&P Euro Plus (U.S. Dollar)	1351.7	-0.8	
London (FT-SE 100)	4783.6	-0.5	
Paris (CAC 40)	3816.1	-0.3	
Frankfurt (DAX)	4208.8	-1.2	
Tokyo (NIKKEI 225)	11,453.4	-0.6	
Hong Kong (Hang Seng)	13,565.3	-1.4	
Toronto (S&P/TSX Composite)	9022.7	0.0	
Mexico City (IPC)	12,329.2	-2.1	

FUNDAMENTALS

	JAN. 11	WEEK A
S&P 500 Dividend Yield	1.95%	1.93
S&P 500 P/E Ratio (Trailing 12 mos.)	20.0	20.0
S&P 500 P/E Ratio (Next 12 mos.)*	16.1	16.1
First Call Earnings Surprise*	6.91%	7.90

TECHNICAL INDICATORS

	JAN. 11	WEEK A
S&P 500 200-day average	1132.0	1129.8
Stocks above 200-day average	72.0%	76.0
Options: Put/call ratio	0.73	0.68
Insiders: Vickers NYSE Sell/buy ratio	5.80	6.34

BEST-PERFORMING GROUPS

	LAST MONTH %	LAST 12 MONTHS %
Fertilizers & Ag. Chems.	10.5	89.8
Home Entertainment	9.0	67.3
Drug Chains	6.7	59.5
Oil & Gas Drilling	6.1	56.6
Employment Services	4.7	54.1

WORST-PERFORMING GROUPS

	LAST MONTH %	LAST 12 MONTHS %
IT Consulting	-13.3	
Electric Mfg. Svcs.	-10.4	
Air Freight & Couriers	-9.4	
Aluminum	-8.3	
Home Furnishings	-7.2	

EQUITY FUND CATEGORIES

4-WEEK TOTAL RETURN	%	52-WEEK TOTAL RETURN	%
LEADERS		LEADERS	
Japan	7.0	Real Estate	23.9
Diversified Pacific/Asia	4.6	Natural Resources	23.3
Diversified Emerg. Mkts.	2.1	Latin America	20.2
Pacific/Asia ex-Japan	1.6	Utilities	18.5
LAGGARDS		LAGGARDS	
Technology	-5.7	Precious Metals	-10.7
Real Estate	-4.0	Technology	-9.1
Small-cap Growth	-3.6	Small-cap Growth	-0.7
Small-cap Blend	-3.1	Large-cap Growth	3.0

EQUITY FUNDS

4-WEEK TOTAL RETURN	%	52-WEEK TOTAL RETURN	%
LEADERS		LEADERS	
ProFds. USh. Sm. Cap Inv.	10.4	PrFds. Mble. Tcmms. Inv.	56.4
Rydex Dyn. Vent. 100 H	9.9	iShares MSCI Austria Idx.	53.3
ProFunds UltSh. OTC Inv.	9.8	Bruce	48.5
ProFunds Ult. Japan Inv.	9.4	Fidelity Sel. Mdcl. Del.	44.5
LAGGARDS		LAGGARDS	
Apex Mid Cap Growth	-12.4	ProFunds Semicdr. Inv.	-47.3
ProFunds Semicdr. Inv.	-10.8	Ameritor Investment	-42.9
Rydex Electronics Inv.	-10.4	Rydex Electronics Inv.	-34.0
ProFds. Ult. Sm. Cap Inv.	-10.3	Thurlo Growth	-33.9

INTEREST RATES

KEY RATES

	JAN. 12	WEEK A
Money Market Funds	1.78%	
90-Day Treasury Bills	2.33	2.32
2-Year Treasury Notes	3.20	
10-Year Treasury Notes	4.24	4.28
30-Year Treasury Bonds	4.77	
30-Year Fixed Mortgage †	5.70	5.74

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	10-YR. BOND
General Obligations	
Taxable Equivalent	5.10
Insured Revenue Bonds	
Taxable Equivalent	5.33

THE WEEK AHEAD

CONSUMER PRICE INDEX

Wednesday, Jan. 19, 8:30 a.m. EST » Consumer prices for goods and services are forecast to have edged up 0.1% in December, after a 0.2% increase during November. That's according to the median forecast of economists surveyed by Action Economics LLC. Excluding the more volatile food and energy categories, core prices most likely moved up 0.2% for a third straight period.

RESIDENTIAL CONSTRUCTION

Wednesday, Jan. 19, 8:30 a.m. EST » December housing starts probably bounced up to an annual rate of 1.85 million. In November sales slowed to a pace of 1.77 million, the lowest since May, 2003.

BEIGE BOOK Wednesday, Jan. 19, 2 p.m. EST » The Federal Reserve will release its report on regional economic activity ahead of the two-day monetary policy

meeting scheduled for Feb. 1-2.

The consensus estimate from Action Economics is for another hike in the federal funds rate, to 2.5%, from 2.25%.

LEADING INDICATORS Thursday, Jan. 20, 10 a.m. EST » The Conference Board's December index of leading economic indicators very likely increased 0.2% for a second consecutive month, after five straight monthly declines.

The BusinessWeek production index climbed to 238.4 for the week Jan. 1, and 11.6% from the year. Before calculation of the week moving average, the index surged to 242.7.

BusinessWeek

For the BW50, more investment data, and the components of the production index visit www.businessweek.com/magazine

the Companies

Index gives the starting page for a story or feature with significant reference to a company. Most subsidiaries listed under their own names. Companies listed only if they are not included.

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Social Security: The Pros and Cons Of Private Accounts

GET SET FOR THE biggest political brouhaha of our time—the battle over Social Security. Before the nation gets swept up in rhetorical excess, it might be wise to step back from Republican shouts of “crisis” and Democratic accusations of “wrecking the safety net” to take a pragmatic look at the issues at hand. Fortunately, once we get beyond the blistering heat of political discourse, the economic choices on Social Security become much clearer, and perhaps less threatening.

The Bush Administration says that there is a crisis in the Social Security system and that private accounts can help solve the problem. The first statement is false, but just because some Republicans are hyping the issue doesn't mean private accounts are a bad idea. They are, in fact, worthy of consideration.

“Crisis” implies immediacy, and there is nothing in the years or even decades ahead that suggests any crisis. Higher productivity and economic growth rates are pushing back the date when the Social Security trust fund runs dry. Federal actuaries say it will now be 2042. The Congressional Budget Office says it will be 2052. Until then, retiring baby boomers get 100% of their benefits. Worst-case scenario: If nothing at all is done to reform Social Security, payroll taxes will still cover 75% of the benefits afterwards. With net worth rising to record levels, let's be honest. Social Security is a problem, not a crisis. What are the solutions?

Private accounts are worth considering. But they are no panacea. Despite what ardent advocates say, the investment returns in private accounts cannot make up the entire \$3.7 trillion shortfall in Social Security. But they can add up. And private accounts have other virtues. You own them, you have investment choices, and you can pass them on to your heirs. And a prefunded retirement system, in principle, is financially sounder than the current pay-as-you-go system.

But private accounts come with costs. The first comes in the form of risk. The experience with 401(k) retirement accounts shows that many people fail to invest enough or diversify sufficiently to maximize their returns. Low-income workers, who need safety the most, are much less likely to participate. The same is likely to happen with private Social Security accounts, hurting many, if care is not taken.

Then there is the \$2 trillion it will cost the government to switch to private accounts. For a budget that is already in deficit, these extra trillions could send interest rates high. The White House is trying to convince Wall Street that the cost doesn't count because it will be offset by a reduction in government's \$3.7 trillion in Social Security liabilities. Therefore the debt won't raise rates.

Don't bet on it. The cost of long-term entitlement programs such as Social Security and Medicare is not priced into financial markets. When the new Medicare drug benefit was passed in 2004, increasing government unfunded liabilities by \$8 trillion, the markets didn't move. The lesson is that financial markets don't react to long-term implicit liabilities of the government, only real IOUs. Let's be honest about the cost of transition to private accounts. Rates may rise, and Federal Reserve Chairman Alan Greenspan is said to be concerned.

Let's also be honest about Social Security benefits. Without private accounts, benefits must be trimmed for Social Security to be solvent in the long run. A plan put forth by

They make sense for some people, but they come with costs

Bush appointed commissions would switch the indexing of Social Security benefits from wages to prices. Current Social Security checks cover 42% of the average worker's wages. The change in indexing would cut that to 20%. This is draconian. The White House is considering less drastic methods of cutting benefits (except raising the payroll tax rate).

The Democrats say Social Security can be fixed without

introducing the risks and costs of private accounts. They propose a mix of raising the payroll tax rate, increasing the cap on payroll tax above \$90,000, and boosting the retirement benefits.

The truth is that despite their political differences, the proposed Republican and Democratic plans to reform Social Security differ little in outcomes. A plan commissioned by the White House cuts the \$2,032 per month that Social Security now promises to deliver in 2075 to \$1,615. One much-discussed liberal proposal cuts promised benefits by 8.6%, to \$1,888. That's a difference of only \$242 a month some 75 years in the future when just about anything can happen.

As negotiations over Social Security proceed in the months ahead, politicians would serve the public well by considering a practical mix of solutions to the problem. Private accounts make sense for many, but a voluntary system might fail to attract the very people who need it most.



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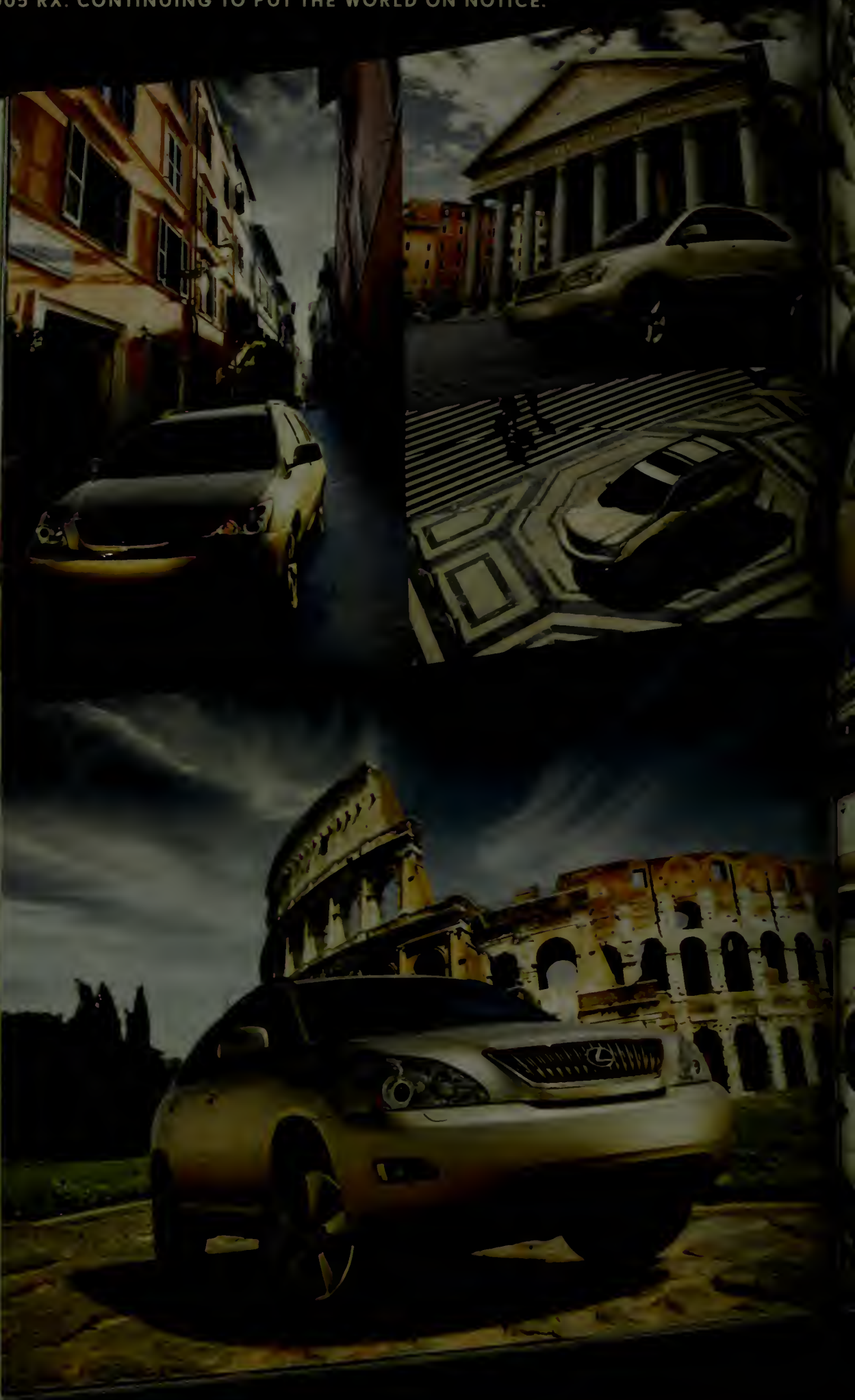
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A photograph of a polar bear mother and her cubs in a snowy, icy environment. The mother bear is in the foreground, looking towards the right. Two cubs are visible: one is partially hidden behind her, and another is in the lower right foreground, looking towards the camera. The background shows a vast, icy landscape under a clear sky.

protection

growth

ANNUITIES

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VELVET GLOVE

Linus Torvalds runs Linux not by autocratic fiat but by making people trust him



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It started off as a cooperative software project. Now the open-source operating system is threatening Microsoft's Windows. Linux is cheaper and more stable; Microsoft's is pricey in the long run. But with 24% of users choosing Linux, a battle royal is heating up between the two systems—and very different business cultures

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FRIDAY, AUGUST 19, 2003 - VOL. CXXII NO. 43 - ***** \$1.00

When it came to our tasting of "white goods," the superpremiums ruled the day. Here, our top three in each category, plus our tasters' comments:

LIQUOR BRAND/PRICE* OUR AWARD

TOP 3 GINS

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Tanqueray No. Ten
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Wal-Mart: Better Days May Be On the Horizon

The retailer has announced an image-burnishing public relations campaign to quell criticism over its labor practices. But positive economic factors may be what pushes the behemoth's growth into overdrive

Can NBC Universal Measure Up?

CEO Jeffrey Immelt hardly seemed like a future media mogul when he took the helm in 2001, but he has doubled GE's bet in the video business—and he may not be done. Given its rivals' size and the shortage of potential acquisitions, however, the options are limited

Tech Product Review: Cool Looks, Hot Sounds

Sunglasses that double as a digital-music player may sound like a weird hybrid, but the Oakley Thump is more than just a novelty. Let us know what you think: Our reviews are now interactive, so chime in

A Hat Trick for Electronic Arts

Its third big deal in a short period locks up a 15-year licensing agreement with ESPN, giving the video-game maker exclusive rights to the network's content—including the popular *X-Game*. More important, it keeps rivals Sega and Take Two on the bench

Turning Europe's Tech Industry Green

This year and next, two new European Union environmental rules will cause manufacturers to change their ways—and it could be quite costly

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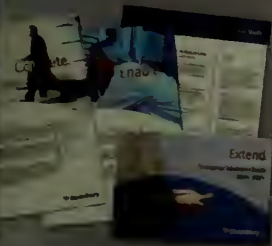
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Fulfilling Dreams

Science For A Better Life



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—Richard Branson, Virgin Atlantic founder, on his airline's offering casinos and double beds on its six new Airbus A380 planes

BY IRA SAGER

CUTIVE SUITE

OS: S ROOM THE TOP

Chief operating officer could become a thing of the past. Since the dot-com burst, the number of companies with COOs has fallen, from 16 in 2000 to 11 last year, according to a survey of more than 100 large companies by the executive search firm Zafirovski & Associates.



ZAFIROVSKI Former chief operating officer at Motorola

On Jan. 12, Motorola became the latest to drop the title, with the departure of Mike Zafirovski. Months after he was let go, CEO Ed Zander announced this will help him get to the company's four business units. "I want to

have one-on-one time," he says. Other companies that have abolished their COO positions in recent years include General Motors, IBM, and Procter & Gamble.

For years, the COO post was considered critical, to free up the CEO for strategic issues or as the final stop for an exec groomed for the top job. But today, investors demand CEOs who know every corner of their business, and reforms such as Sarbanes-Oxley impose greater accountability, forcing CEOs to be more hands-on.

Chief financial officers' expanding roles now often overlap with COOs', too.

A CEO-in-waiting recruited from the outside might benefit from a stint as COO. Barring that, fewer companies seem willing to pad the payroll with another high-paid exec.

—Louis Lavelle



TRADING FUTURES
At the Chicago Board of Trade

HOT SEATS

Updraft in the Windy City

IN 2003 A SEAT on the Chicago Board of Trade sold for just \$338,000, compared with \$2 million for one on the New York Stock Exchange. But in early January a seat on the Chicago futures exchange changed hands for \$1.25 million—just off a November high of \$1.4 million. Meanwhile, the price of a seat at the NYSE has eroded to a nine-year low of \$975,000, thanks in part to uncertainty over plans to automate more trading. It's the first time in roughly 20 years that a CBOT membership is priced higher than that of the NYSE.

The secret to the dramatic uptick in the price of a CBOT seat has been success. The exchange traded nearly 600 million contracts in 2004, up 32% from the previous record year. Plus, new technology and price cuts have helped stave off low-cost electronic rival Eurex U.S., which opened last year.

It also hasn't hurt that shares in the Chicago Mercantile Exchange, the city's other major futures bourse, have soared from \$35 to a recent \$206, since a December, 2002, initial public offering. The CBOT has filed restructuring plans with the SEC, a step that could signal an IPO. If that happens, a seat on the CBOT certainly would be a hot commodity.

—Adrienne Carter

BIG PICTURE

HOT PATTERNS Would you accept an executive job in the troubled airline industry? That's how 371 senior execs answered:

WOULD BE A GREAT CHALLENGE

51%

THE OFFER IS RIGHT

32%

THE INDUSTRY IS TOO VOLATILE

17%



Data: Association of Executive Search Consultants

THE HOME FRONT VIRTUAL IMMIGRATION ENFORCERS

DAVID CAULKETT, a 56-year-old Pompano Beach (Fla.) resident who was laid off as a computer technician two



years ago, blames **NORTHBOUND** illegal immigrants for depressing the country's wages, clogging its courts, and burdening its public services. Tired of "sob stories," he has joined a growing number of Web activists who have taken the crusade against illegals into their own hands.

On his site, **ReportIllegals.com**, anyone can report, anonymously, details on suspected illegal immigrants, such as name, address, and the companies that allegedly employ them. Caulkett charges \$10 but doesn't vet reports from his 8,000 monthly visitors for accuracy, leaving that to the **Homeland Security Dept.**, the **FBI**, and other agencies to which he forwards the complaints.

Other sites, such as **IllegalAliens.us**, **StopTheInvasion.com**, **NumbersUSA.com**, and **Americans for Legal Immigration** (alipac.us), urge visitors to complain to their congressional representatives or law enforcement.

HSD doesn't endorse the sites but says it welcomes the help. The agency publishes a

phone number for reporting suspected illegal aliens free of charge. It deported a record 157,842 people in 2004, up from 145,416 the prior year. Some deportations, HSD says, likely resulted from Web tips.

Immigration supporters are appalled. They say reporting suspected illegals over the Web will result in U.S. citizens being mistakenly fingered, or let people with a grudge turn in innocent victims. "It's almost like vigilantism," says Judy Golub, with the **American Immigration Lawyers Assn.**

Caulkett, for one, is unswayed: "These people have not contributed to our society." Meanwhile, complaints to Caulkett's Web site have risen 10% per month. —*Brian Grow*

CHINA CHECK CHIP SHOT

Given China's economic boom, it was just a matter of time until the nation's chip market clawed its way to the top. That time is now. This year, China will become the world's biggest chip market, predicts IC Insights.

The Scottsdale (Ariz.) researcher thinks 2005 sales of chips in China will reach \$34.3 billion, eclipsing both Japan's \$33.1 billion and North America's \$33 billion. Since 2001, China's market has grown at a yearly rate of 46%. Cell-phone chips are hot, demand for computer chips is even greater.

—*Otis*

DRAWN & QUARTERED



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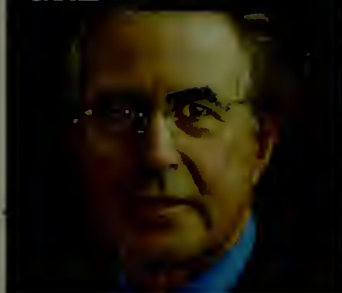
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FACE TIME

GERALD GREENWALD



THIS TIME, HE'S TAKING THE TRAIN

In mid-1999, after five years as CEO of **United Airlines** and 20 years with **Chrysler**, Gerald Greenwald retired to his Aspen (Colo.) home. Now, at age 69, Greenwald is adding railroads to his résumé.

On Jan. 12, **Greenbriar Equity Group**, a \$450 million investment vehicle Greenwald founded, teamed with **Berkshire Partners** to buy North America's largest builder of locomotives: **General Motors'** **Electro-Motive Div.** The purchase is Greenbriar's fourth in the transportation sector.

Greenwald can't seem to stay away from planes, trains, and automobiles, but he does rule out one investment: **United**. When the airline went into bankruptcy in late 2002, he says, he offered to buy a stake but was rebuffed. Today, as **United** struggles to cut costs, he's glad: "I've been saved from myself." Besides, now he has time to travel. A day after inking his rail deal, Greenwald left for a week in the Amazon jungle. No wheeis—just a guide and his own two feet. —Michael Arndt

GIVING

A CORPORATE PEACE CORPS CATCHES ON

LAST YEAR, CISCO SYSTEMS made an unusual donation to nonprofit **NetHope**: an executive director. Dipak Basu took leave from his sales job to run the group, which helps bring high tech to developing nations. On Jan. 10, as relief workers responded to the tsunami disaster, NetHope began setting up wireless networks across Southeast Asia. That let relief workers coordinate efforts via e-mail and cell phone. The volunteer plan has been so successful that Cisco plans to let more staffers work with aid groups.

The model for a corporate Peace Corps is catching on. By pairing top talent with charities, companies are contributing their most



SUMATRA Employees can take paid leave to help

important asset: brain-power. This spring, **Nike** will begin offering

workers with 10 years of service five-week paid sabbaticals to volunteer with aid groups. **Pfizer** and **Price-waterhouseCoopers** already send employees to help nonprofit organizations in developing countries. In addition to building infrastructure, the programs help create goodwill among future cust-

omers in emerging m.

Nonprofit **BuildingB International**, which co businesses to social ca wants to keep the mor going. It's asking Ame top companies to com sending 10 workers to developing countries f 1,000 hours each. So f **Pfizer** has signed on, a **Cisco** and **Nike** are considering. These companies are finding lending a helping han do more good than har over cash. —Jessi J

TINSELTECH

FIRST-RUN FILMS IN YOUR LIVING ROOM?

THIS YEAR, Robert Redford's Sundance Film Festival, long a showcase for indie movies, will also show off technology that could change movie distribution. On Jan. 22, **Intel** will stream an 84-minute film called *Rize* from an Oregon lab via an Internet service provider to Park City, Utah. From there it will be broadcast wirelessly for 11 miles using Intel's new WiMax gear to a

theater screen and a dozen laptops at a Park City lodge.

The idea? To show how wireless broadband can be used to untether digital movies. WiMax, which rolls out this year, can enable distribution of movies-on-demand to theaters, or even homes. While that will take a few years, "it has enormous meaning for filmmakers,"

says Ian Calderon, director of digital initiatives for the Sundance Institute. Studio execs from **Walt Disney**, **HBO**, and **Sony** are expected to watch.

No wonder. Imagine the ability to add digital homes to an opening weekend box office sum.

—Heather Green

THE STAT

62

The percentage of Americans who have no idea what a blog is. (The answer: A frequently updated Web site consisting of personal observations and excerpts from other sources typically run by a single person.)

Data: Pew Internet & American Life Project, Oxford English Dictionary

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[The NFL's] Tagliabue, one of the Best Managers of 2003, [should have been] among your Repeat Performers.

—Steven Battles
Danville, Calif.

BEST AND WORST MANAGERS: READERS' PICKS

YOU HAVE ONE GLARING omission in "The best managers...and the worst" (Special Report, Jan. 10): Paul Tagliabue, one of the Best Managers of 2003, was not among your Repeat Performers. He continues to manage the National Football League spectacularly, expanding globally and continuing to develop the top spectator sport in America. I have not done the math, but I bet Mr. Tagliabue has created more value for his shareholders (NFL owners) during his tenure than most CEOs of companies in existence as long as the NFL. He is one of the most respected commissioners in the history of any sport.

—Steven Battles
Danville, Calif.

CALLING RODALE INC. "a once-sleepy company" before the arrival of Steven Murphy does a disservice to former CEO Ardath Rodale. Assuming her husband Bob's role after his death in an auto accident in Russia in 1990, "Ardie" more than doubled revenues during her term, launched the profitable *Men's Health* international business, revitalized and

repositioned *Prevention*, expanded and recruited top editorial talent (including the editor who brought *The South Atlantic Diet* to Rodale), and led what publishing industry experts called one of the best blends of Internet and traditional print resources.

Murphy may be a great manager, but he is harvesting a crop planted and nurtured by Ardie Rodale.

—Bob Emmet

Editor's Note: The writer was president and chief operating officer of Rodale Inc. from 1979 until his retirement in 2000.

I WAS CURIOUS about the selection of Anne M. Mulcahy as one of the Best Managers of 2003 while Franklin D. Raines was chosen as one of the worst. It is difficult to disagree with your selection of Mr. Raines, but the misstatement of Fannie Mae's financial results is one of the more egregious examples of corporate malfeasance in recent years. Enron Corp. While Ms. Mulcahy has been successful in turning around Xerox Corp., what was she doing at Fannie Mae? Shouldn't one of the "best" managers, especially with her experience

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RECTIONS & CLARIFICATIONS

Microsoft's CFO will split" (In Business Week, Jan. 24), we failed to factor in Microsoft Corp.'s February, 2003, 2-for-1 split in our calculation of the stock's performance during John Connors' year tenure since January, 2000, as financial officer. Microsoft shares ended 51%, not 74%.

"The cash heads home" (News: Analysis & Commentary, Dec. 27) about corporations repatriating overseas earnings: The table "Overseas stash" used was provided by the non-profit Citizens for Tax Justice, and was based on a methodology which included cumulative repatriated foreign earnings for companies that were profitable in the U.S. in years 2001, 2002, and 2003. Companies that were not profitable in the years were excluded, and we should have noted that.

Xerox' accounting problems, have we a more vigilant director? Xerox CEOs appear to have a problem with directorships and audit committees. L. Allaire, CEO during the accounting scandal, chaired the audit committee of Xerox Technologies Inc. during its accounting problems. Is there something in the drinking water at Xerox' corporate headquarters?

—William Cobb
Bronxville, N.Y.

Editor's Note: Allaire chaired Lucent's audit committee in fiscal 2000. In May, Lucent Securities & Exchange Commission charges over problems with its 2000 accounting.

LEFT OUT Bruce R. Lakefield, the CEO of US Airways Group, as a worst offender. As his company was going into a downward spiral over the baggage debacle in Philadelphia during the Christmas holidays, CEO Lakefield was nowhere to be seen. Instead of coming forward and taking charge of the situation, Lakefield sent other men in his place. Where was the executive—too busy packing his parachute?"

—Leon Reinstein
Baltimore

THING IN ON RUMSFELD AND ROVE

"THE BUSH TEAM" (Washington Post, Jan. 10): Many Americans are disappointed by Donald Rumsfeld and his performance against America's enemies. Al-

most 70% of those serving in the military support him. *BusinessWeek* should not embarrass itself by attempting to second-guess a Defense Dept. that has led the world in the war on Islamic terrorism.

I subscribe to read about business, not politics.

—Patrick Stansbury
Snellville, Ga.

INCLUDING KARL ROVE in the list of best managers makes a mockery of all businesspeople who achieve their results ethically and with integrity. Why not put Kenneth Lay on the list, since he reached his goal, too—for a while, anyway. Please name one other corporation in 2005 that operates under the "means justifies the end" philosophy that is not in court or under some sort of sanction.

—Nancy Adams
Midlothian, Va.

DELL COMPUTERS ARE BUILT BY DELL WORKERS IN DELL PLANTS

CONTRARY TO A recent letter ("Reading the fine print on IBM's China deal," Readers Report, Jan. 17, in response to "China goes shopping," News: Analysis & Commentary, Dec. 20), Dell Inc. computer systems are built to customer specifications by Dell people in Dell plants. Most systems for U.S. customers are built, one at a time, in Austin, Tex., and Lebanon, Tenn. Further, Dell recently announced we would add to our U.S. manufacturing operations with a third location, in Winston-Salem, N.C. We also have manufacturing operations in Ireland, Brazil, Malaysia, and China to serve our millions of customers in other parts of the world.

—Lynn Antipas Tyson
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Why You Lost All That Money

BLOOD ON THE STREET The Sensational Inside Story of How Wall Street Analysts Duped a Generation of Investors
By Charles Gasparino; Free Press; 355pp; \$26

Imagine scenes like these: At Citigroup, star research analyst Jack Grubman snorts cocaine with an unnamed telecom executive. At Morgan Stanley, despite an official separation between research and investment banking, Internet analyst Mary Meeker approves and nixes potential deals. And Henry Blodget,

Merrill Lynch & Co.'s star Internet analyst, complains one week of spending 85% of his time helping investment bankers, and says at least half should be going toward his real job—research.

Such episodes fill the pages of *Newsweek* Senior Writer Charles Gasparino's *Blood on the Street: The Sensational Inside Story of How Wall Street Analysts Duped a Generation of Investors*. Grubman declined to answer *BusinessWeek's* questions about drug use or any of the book's other allegations. Blodget and Meeker also declined to comment.

Gasparino's picture of how top research analysts and their investment bank bosses preyed on unsuspecting individual investors—only later to become fodder themselves for regulators and class-action lawyers—is both the most detailed and the most damning so far. This is hardly the first account of how analysts became willing shills for investment bankers during the stock market boom of the late '90s. And there are shortcomings: It's occasionally hard to tell where the author's assertions come from, and his sometimes squalid chronicle tends to wander. But because of Gasparino's deep knowledge of the players, a result of his reporting at *The Wall Street Journal*, *Blood on the Street* is a key account of an era of pervasive greed and hubris.

The book's first half focuses on Grubman, Meeker, and Blodget. But Grubman, barred from the securities industry in 2003, steals the show. What differentiates him from the other two, even though Blodget was also barred, is that his research was "hype [that] surpassed anything Wall Street had ever seen," Gasparino writes. The author sprinkles details of Grubman's acts throughout the book—how the analyst carried on a sexually explicit e-mail relationship with a money manager; how he walked around the hotel lobby at an AT&T conference in his underwear; and how he made "obscene noises" when AT&T's then-CEO, Michael C. Armstrong, spoke during analyst meetings.

Gasparino is equally critical of Grubman's boss, Citigroup Chairman Sanford I. "Sandy" Weill. Relying primarily on e-mails produced by New York Attorney General Eliot Spitzer's investigations, Gasparino describes how Grubman

went from being a thorn in Weill's side to being an employee so highly valued that Weill donated \$1 million of Citigroup money to help get Grubman's children into Manhattan's exclusive 92nd Street Y preschool. Why? Gasparino alleges that Weill needed Grubman to raise his rating of AT&T's stock. In exchange, Weill got Armstrong, then on the Citigroup board, to vote for the ouster of the financial behemoth's co-CEO, John Reed. Once Reed was out of the way, in 2000, Weill took control. But Gasparino fails to provide real evidence of these schemes. Through a spokesperson, Weill declined to comment.

Like a relentless boxer, Gasparino takes jabs at regulators who let analysts and their bosses get away with duping investors. Former Securities & Exchange Commission Chairman Arthur Levitt Jr. is depicted as talking a lot about analyst misdeeds but never taking action. And though the account is generally favorable to Spitzer, Gasparino describes

him as a publicity hound. An example: The author says Spitzer fined Merrill \$100 million for issuing misleading Net research—in large part because *Wall Street Journal* Managing Editor Paul Steigman jokingly remarked that it would take a fine that large to justify a front-page story. Steigman confirms the conversation. A spokesman says Spitzer disagreed with the characterization of the meeting and insists there was no connection between the fine and the alleged conversation.

Along the way, Gasparino shows sympathy for former New York Stock Exchange Chairman Richard A. Grasso's dramatic rise and fall. And former SEC Chairman Harvey L. Pitt appears to

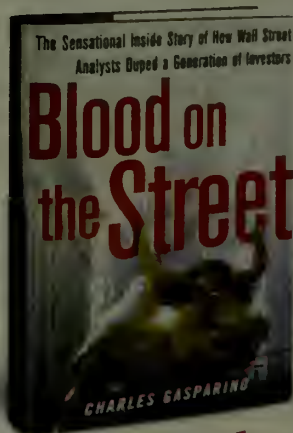
be the agency's most effective regulator, canned in part because he failed to see the political value of publicity, instead of trying to settle matters quietly.

Alas, despite its hard-nosed reporting and many on-the-mark criticisms, *Blood on the Street* lacks a sustained narrative thread. It also fails to offer a final judgment on Wall Street analysis. After all the

reforms, is today's research reliable? "Only time will tell," Gasparino concludes.

Still there probably won't be a better book about these events. Notes Gasparino: "This is a story where there are few heroes, and even fewer people willing to provide an honest account of what went wrong." *Blood on the Street* will take most readers as close to the action as they are likely to get—and few will come away comfortable with what they learn.

—By Emily Thorrold



The most detailed and damning account so far of the '90s stock boom



More bars in more places.

Cingular and AT&T Wireless have joined forces to bring you the largest digital voice and data network in America. It's called the ALLOVER™ network. Cingular will continue to build this network, giving you more signal bars in more places and more people to talk to. It's our promise to improve wireless every day. cingular.com

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bars claim compares Cingular's network before to after merger. The ALLOVER network covers over 268 million people and is growing all the time. Coverage not available in all areas. ©2005 Cingular Wireless. All rights reserved.



BY STEPHEN H. WILDSTROM

When a BlackBerry Is Overkill

You'd like to get e-mail on the go—and on a wireless phone that's a lot smaller than a BlackBerry. You can't quite have your cake and eat it, but if you are willing to forgo some e-mail functions and do e-mail without a keyboard, the latest phones using Microsoft's Windows Mobile Smartphone software could be just the ticket.

I took a look at two new models. One is the Motorola MPx200, a compact flip-phone available for \$320 with a two-year contract from Cingular Wireless. The other is the Audiovox SMT5600 (\$199, also from Cingular), a bar-type phone small enough to slide easily into a pocket.

Both feature big—by phone standards—and sharp displays, but they're still only about half the size of the screen on the palmOne Treo. Because both phones run Microsoft software, they offer pretty much the same functions. The Motorola has a better camera, and the buttons on it are less cramped than on the smaller Audiovox. The Motorola also has Bluetooth wireless that can be used for cordless headsets, hands-free attachments for car use, or an external speakerphone. Neither model has a speakerphone built in—a crucial omission. Ultimately, the decision between these two phones comes down to whether you prefer a flip or bar design.

UNLIKE A TREO, BLACKBERRY, or Pocket PC Phone Edition, the Smartphone is primarily a wireless handset. Like the bigger PDA phones, it syncs with Microsoft Outlook, and you can dial numbers directly from the contact list. But the Smartphone suffers in its data capabilities. The software includes a version of Internet Explorer that, in theory, is a lot more capable than the browsers on most phones. But it really works only with pages specially formatted for small displays, and even then, type can be woefully hard to read.

The usefulness of the e-mail varies with your mail setup and how you plan to use mobile messaging. The only mail program on the Smartphone is a version of Outlook. When you sync with your desktop, messages in Outlook are copied to your phone and any messages you have written on the phone are sent. Some corporate mail systems based on Microsoft Exchange can send messages as

AUDIOVOX
SMT 5600



**The phones
are fine for
reading, but
not writing,
e-mails**

well as contact and calendar updates over the

While Treos, Pocket PCs, and BlackBerrys have standard software to access regular Internet e-mail accounts, Smartphones don't. There are ways to work around this. I used a service called 4SmartPhone (4smartphone.com), which collects mail from my Internet service provider's postbox and forwards it to Outlook on the handset. The service starts at \$4.99 a month on top of a Cingular voice and data plan starting at about \$55. Another possibility is Cingular's Xpress Mail, which lets you forward mail from your desktop. This gives access to mail stored behind a corporate firewall, but

may violate company security policies, and it won't work if your primary computer is a laptop you don't travel with you. Pricing starts at \$60 a month, including a voice plan—the same amount you might pay for Cingular service on a Treo 600 or BlackBerry 7230.

Aside from voice calls, the Smartphone is useful mainly for reading e-mail. The screen displays 10 lines of about 25

characters. But I didn't enjoy tapping out text on the dial pad (The Microsoft-based Voq Professional Phone from Sierra Wireless has a fold-out keyboard. But it's bulky and isn't available by U.S. carriers, so it costs an unsubsidized \$550 or so.)

Both the Audiovox and the Motorola offer everything you expect in a high-end handset and then some, with the Motorola having a slight advantage in capabilities and battery life, while the Audiovox is smaller. As a heavy e-mail user, I'm not prepared to give up the bigger screen and vital keyboard that a Treo or BlackBerry provides. But if your mail needs are less intense, a Smartphone may be the right choice for you.

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imagination at work



BY JEFFREY E. GARTEN

The High-Tech Threat From China

The news is full of headlines about China—its rising trade surplus, ballooning currency reserves, relentless search for oil, and its tensions with the U.S. over textiles and intellectual property rights. But one development has been seriously underreported: China's emergence as technological superstate. Could Beijing pose a threat in the one area

where the U.S. has assumed it would always retain supremacy?

Since 1985, China has repeatedly declared its resolve to reach technological parity with the West. Between 1992 and 2002, the latest period for which figures are available, Beijing has more than doubled the proportion of gross domestic product it spent on research and development, while the level stagnated in America. China boosted its output of PhDs in science and engineering by 14% a year, while the number of U.S. grads fell. Its technology-intensive exports grew by 22% annually, while exports of U.S. high-tech goods have declined. Today, moreover, while American universities award 25% of all their PhDs in science and engineering to Chinese citizens, Beijing is sparing no effort to lure many back. Among China's R&D priorities are superscale integrated circuits, computer software, and information security systems.

WESTERN COMPANIES ARE SPEEDING up China's advancement by establishing huge R&D facilities there. General Electric Co. has 27 labs in China working on projects from composite-materials design to molecular modeling. Microsoft Corp. has nearly 200 researchers in the country. Cisco, DaimlerChrysler, IBM, Intel, and many others are following suit.

Experts are split on the implications of the globalization of R&D. In a forthcoming report, for example, Nicholas Lardy of the Institute for International Economics downplays China's technological position by pointing to the relatively low sophistication of even its high-tech exports, its heavy dependence on imported technology, and the benefits that accrue to U.S. companies investing there. On the other hand, in an upcoming book, Ernest Prege of the Manufacturers Alliance/MAPI is sounding alarms because of China's steep upward technological trajectory. In a recent study, Kathleen Walsh of the Henry L. Stimson Center calls for Washington to wake up to the economic and national security implications of China's growing R&D capabilities. And the National Science Foundation is upset by the decline in research funding and scientific education in America.

I fear that the U.S. hasn't come to grips with the implications of corporations doing so much R&D in China. U.S. companies are understandably seeking the best talent and lowest cost of operations anywhere. But in the process

they are sharing America's intellectual treasures with a foreign rival in unprecedented ways. They are training scientists and engineers and giving them and the omnipresent Chinese government access to their proprietary research programs.

To keep its undisputed technology lead, the U.S. must go beyond larger government-sponsored research budgets, better K-12 education, and closer government-business cooperation, all prescriptions made in the 1980s, when the U.S. last had a competitiveness debate. Now Washington must also figure out how to deepen basic R&D in America when so much is dispersed abroad. And it must adapt to the reality that U.S. multinationals' goals may no longer dovetail

with national interests. I've never seen a way to achieve all the goals at the same time.

America Inc. is rushing Beijing ahead by sharing R&D treasures

Intel Corp. is illustrative. Craig Barrett advocates more federally funded research, which would eventually benefit the country and the company. But Congress and the public have wondered whether Intel should receive, in effect, subsidies if it then shares its knowhow with Chinese partners. At the very least, a quid pro quo should be

established. Intel's sharing of technology could enrich its shareholders, China's economy, and to some extent the U.S. But unlike in the past, its goals no longer center on creating industries and jobs in the U.S., which is what American taxpayers deservedly expect.

In the 1960s, Americans were galvanized by Sputnik, and in the 1980s they were spurred on by Japan Inc. As the challenge of remaining technologically superior becomes more complex, the U.S. needs another shot of adrenaline. The perceived threat of China could supply it, but I worry that the U.S. won't be strong enough or soon enough. ■

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AMES C. COOPER & KATHLEEN MADIGAN

Strong Demand Is Firing Up U.S. Factories

After running lean, they're gearing up to fill orders and build inventories

U.S. ECONOMY There is no question that the economy's strength in the year's second half was surprising. Despite high oil prices, election uncertainties, and constant geopolitical jitters, consumers picked up their spending pace, and business showed heightened eagerness to roll out for new equipment. The good news for 2005 is these gains

and are lifting U.S. production and intensifying efforts to beef up inventories. And because the U.S. is the world's growth engine, solid American demand will help overseas economies as well, eventually helping exporters to take advantage of the dollar's competitiveness.

That demand-driven momentum should be a key theme of the Commerce Dept.'s report on fourth-quarter gross domestic product, due on Jan. 28. Spending by consumers, businesses, and governments for all goods and services grew at a 4.9% annual rate in the fourth quarter, and it appears to have increased near that pace in the fourth quarter. That's about a full percentage point faster than the pace in the first half.

Not all of this demand strength will show up in the headline of real GDP. That's because a significant share of spending is being satisfied by foreign, not U.S., consumers as imports surged. In fact, exports fell because of weak foreign demand. Overall, a sharply wider trade deficit, as seen in the October and November data, is expected to have subtracted between 1.5 and 2 percentage points from overall GDP growth last quarter.

At the same time, however, businesses seemed to have built up inventories at a much faster pace than in the third quarter, reflecting efforts to keep up with strong demand. Based on data through November (chart), business inventory growth probably contributed about a percentage point to last quarter's GDP growth.

Of course, Commerce will have the final say, but given the three expectations, overall GDP growth was probably in the range of 3.5% to 4% last quarter. Even the lower figure, average growth last year was at an annual rate, the strongest showing since 1999. Domestic demand posted the best yearly advance in four years despite the big drain from costlier energy.

2005, DEMAND once again holds the key to the outlook. The momentum implied by the fourth-quarter report and the strong yearend data bodes well for the first quarter. Business spending is buoyed by strong earnings and cash flow, high profit margins, the easiest financial conditions in years. And the labor markets improving and confidence

rebounding, households also began 2005 on firm ground.

One potential trouble spot: Crude-oil prices were back up to nearly \$48 per barrel on Jan. 19. Costlier heating oil will take a bite out of household budgets, especially in the Northeast, but the broader impact might not be felt until the spring driving season, if prices stay up. Based on their historical relationship, crude oil at \$48 per barrel has

implied gasoline prices of about \$2 per gallon. In mid-January, gas averaged \$1.82. So gas prices could rise again in coming months, crimping purchasing power.

For now, households are doing just fine. December retail sales jumped 1.2%, lifted mainly by a spike in car buying. Excluding autos, sales rose only 0.3% in

the month, but for the entire fourth quarter they grew at an annual rate of 9.1% from the previous quarter, nearly double the third-quarter increase. The surge in retail sales all but assures that real consumer spending grew at least 4%, following the third quarter's 5.1% advance.

Moreover, measured from the previous year—the way chain stores report their numbers—sales during the holiday period don't look Grinchy at all. December receipts at general merchandise and clothing stores were up 6%, the strongest yearend showing since 1999, according to Commerce's accounting. Plus, sales at nonstore retailers surged 14.3%, compared with the 8.6% increase in December, 2003, implying a big pickup for Internet and catalog shopping.

THE CRUCIAL CARRYOVER into 2005 will be the boost this robust yearend demand gives to industrial production, both in the U.S. and abroad. The lift is already showing up domestically. Output in the nation's factories, mines, and utilities jumped 0.8% in December. During the past three months, output growth

BUSINESSES STOCKPILE MORE GOODS



has accelerated to an annual rate of 7.5%, the strongest three-month advance in a year (chart). The gains have been broad, led by a pickup in high-tech equipment.

A key reason production has accelerated is the dearth of inventories. From August through October, companies worried about the potential negative impact on demand from higher oil and gasoline prices. But spending never wavered and by November businesses felt confident enough to boost their stockpiles by a large 1%. Even so, the ratio of inventories to sales for manufacturers, wholesalers, and retailers was still only 1.31 in November, close to a record low. Retailers, in particular, ordered cautiously for the holidays, so heading into December, nonauto retailers held a near-record low level of inventories in relation to sales.

IN GENERAL, THE SHIFT to just-in-time inventories has lowered the inventory-sales ratio over the last 15 years, but the danger is that companies can more easily get caught short if demand picks up suddenly. That seems to be happening now. For manufacturing, where shipments and orders are rising strongly, most of the November inventory increase occurred in finished goods and work-in-process. Yet that stockpiling may not have been enough. In December purchasing managers at industrial companies noted that current and expected demand required higher inventory levels. They also said that their customers do not have sufficient inventories on hand.

Interestingly, during the past three months, wholesale inventories have risen twice as fast as nonauto retail

stockpiles. That suggests a good bit of the faster inventory growth of late can be attributed to imports. Indeed, imports of nonoil goods posted strong gains both October and November.

Those advances are part of the reason the trade deficit ballooned in the fourth quarter. Imports last quarter

adjusted for price appear to have grown at an annual rate of more than 10%, after increasing only 4% the third quarter.

Obviously, foreign producers are benefiting from robust U.S. spending, which should help employment, confidence, and demand overseas. U.S. exports seem to have declined

last quarter, but the purchasing managers' index of export orders rose strongly in December, suggesting that first-quarter shipments will post a much healthier showing.

The bottom line is that last year's broad pickup in demand has implications for both the U.S. and economies abroad. Despite the rise of China, the U.S. still accounts for more than a quarter of the volume of world merchandise trade. And in an increasingly interdependent world, strong U.S. growth will also tend to lift American exports. ■

COMPANIES REV UP THEIR ASSEMBLY LINES



SPAIN

Growing Risks for a Star Performer

SPAIN'S ECONOMY heads into 2005 looking pretty good with growth expected to be among the best in the euro zone. But the country faces growing risks that could upend its long run of stellar performances.

Domestic demand continues to fuel growth. Car sales rose in December from the year before by 3.2%, and the purchasing managers' index for the service sector bounced to 53%, from 52% in November. Thanks to strong demand, November industrial production rebounded, up 3.9% from the previous year, after a 1.5% fall in October. Consumer goods output alone rose 3.9%.

A healthy labor market and rising real wages are set to keep

the economy humming. The number of registered unemployed fell by more than 12,000 persons in December and was lower overall in 2004. That was the first yearly fall since 2000. Plus, the government upped the minimum wage by 4.5%, effective Jan. 1, and pension payments, linked to inflation, are set to rise by 3.5%.

But strong demand at home is feeding inflation. Although prices fell 0.1% in December, they still stood 3.3% above their previous-year levels. Cheaper fuel helped to ease price pressures last month, but BNP Paribas economist Marie-Laure Michaud says inflation will stay above 3% this year.

That inflation rate continues to outpace the euro zone average,

which was just 2.2% in November. At the same time, the euro is on the rise. That combination will weigh on growth by crimping exports and making imports more attractive. Tourism industry, which makes up close to 12% of Spain's economy, also suffers, especially if the other euro zone economies remain stagnant.

But a larger threat to growth looms on the horizon. Low interest rates touched off a housing boom in 1990s years. Most economists expect the European Central Bank to begin raising interest rates around the middle of this year. Since most mortgages in Spain are variable, borrowers would see interest costs increase when rates go higher. Climbing interest expenses would slow down the housing market, the robust construction sector, a most likely put a damper on consumer demand. ■

—By James Mehring in New

THE INFLATION GAP WIDENS





Byron Wien, US Senior Investment Strategist

Looking down the road for 2005.

10 surprises to keep you ahead of the curve.

The Surprises of the New Year are meant to challenge investors to reflect on the important issues facing the market. Events generally develop quite differently from what most investors anticipate, so it is useful to try to choose which components of the consensus are going to be wrong. This is the 20th edition of The Ten Surprises.

1. Crude oil takes the trophy for the most volatile commodity of the year. After dropping to \$30 a barrel, it rises to \$60 as a result of supply/demand imbalances and disruptions in shipments. There are no drawdowns of the Strategic Petroleum Reserve, but drilling in the Arctic National Wildlife Refuge passes in Congress.

2. While the Bush Administration continues to support a strong dollar policy, it also maintains that market forces should be allowed to set the level of the currency. The orderly decline gives way to a sharp drop, and the euro goes to 1.50 and the yen to 85. Europe and Japan call for a second Louvre Accord to reverse the trend. In spite of the currency weakness, the US trade deficit continues to rise.



3. The yield on 10-year US Treasury Notes rises to 6.00% in the second half of the year. Among other causes, Japan and China reduce their purchases of US bonds. Although inflation remains moderate and the economy is not overheating, the Federal Reserve raises rates at every

meeting and the federal funds rate ends the year at 4.25%. Greenspan admits that "real rates have been too low for too long."

4. The US equity market goes nowhere after two years of gains. Responding to higher interest rates, excessive investor optimism, continuing international tension, a declining currency, and an overextended consumer, the S&P 500 ends the year flat in spite of a reasonably strong economy and corporate earnings improvement.

5. Resisting pressure from its trading partners, China refuses to change its currency system. It rejects the "basket of currencies" approach, saying it prefers to remain pegged to the dollar because of a commitment to economic stability, employment increases, and a continuation of reforms. China's growth stays near 9% as it expands its infrastructure and industrialization westward. Commodity prices persistently rise, and certain chemical stocks do well.

6. Japan slips back into recession as the yen strengthens and exports to China prove inadequate to keep the economy going. Investors begin to question the ability of Japan to thrive as a high-cost producer

in a low-cost region. The Nikkei 225 approaches 10,000 again.

7. Vladimir Putin's hard-line policies finally prove too much for the Russian people. Revelations of widespread corruption, on top of the Ukraine election controversy, precipitate a second Russian Revolution, and Putin resigns. The economy slumps, the ruble weakens, and the Russian market declines 25%.

8. While oil and gas producers and refiners and marketers do well in the US equity market, oil service and other energy infrastructure stocks are standouts. Coal also continues its resurgence, and stocks with major coal exposure have substantial upside.



9. Following a terrific 2004 harvest that drove some agricultural commodities to distressed levels, the summer growing season is alternately too cold or too hot, rain is infrequent, and worldwide food demand increases. Corn, soybean, and wheat prices rise sharply. Companies entering the year with large inventories are big winners.

10. The Bush Administration overreaches on domestic economic legislation. Citing the high transition costs and the uncertain benefits, both Republicans and Democrats defeat partial privatization of Social Security. The year isn't a total washout, however. Congress confounds the skeptics and puts limits on plaintiffs' lawsuit damages. Concern about a doctor shortage outside of major cities convinces a number of Democratic members to support tort reform.

The ground rules for the surprises are that the consensus would assign only a one-in-three probability to each of them, but my view is that each has a 50% chance or better of taking place.

Byron Wien
US Senior Investment Strategist

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THE ECONOMY

WHY GREENSPAN ISN'T THAT WORRIED

Some of his colleagues see looming inflation risks. But the Fed chairman isn't likely to shift gears

AS THE FEDERAL Reserve prepares to hold its first monetary meeting of the year on Feb. 1-2, financial markets are bracing themselves. Investors fret that Alan Greenspan and his central bank colleagues are about to junk their go-slow strategy of bite-size interest rate hikes in favor of something more aggressive. And that uneasiness is certainly understandable given what the minutes of the Fed's last meeting on Dec. 14 showed. According to that record, some policymakers are openly anxious about a breakout of inflation. Other officials, in a throwback to Greenspan's irrational exuberance comments of yore, are working the worry beads over what the minutes call "exces-

sive risk-taking" in financial markets.

What's fueling those concerns? The minutes—which don't identify the worries—point to the return of corporate pricing power, a weak dollar, still-elevated energy costs, and slowing productivity growth as signs that price hikes could soon accelerate. And in the financial markets, Fed officials cited low corporate bond yields and recent pickups in initial public offerings and mergers and acquisitions as indications that easy money is fueling speculation. So it's not surprising that some policymakers are uneasy with the repeated assertions that rate hikes will be measured. They are warning that the Fed may need to be more aggressive. "At some point the measured language will come out of the Fed statement," Federal Reserve Bank of St. Louis President William Poole told re-

porters after a Jan. 13 speech. "There will be a pretty vigorous reaction [by the market] if we should see [inflation] threaten to move to a sustainably higher rate."

HAPPY MARKETS

BUT THOSE CONCERNS don't seem to have fazed the man atop the Fed. Analysts say the chairman has shown no signs of panic and appears content with his strategy of small, slow rate hikes—just a quarter of a percentage point at the last meeting. By more than doubling short-term rates it controls, from 1.25% in June to 2.25% today, the Fed has absorbed much of the stimulus it pumped into the economy after the stock market bubble burst and terrorists attacked on September 11. Indeed, with another 25-point hike expected at the Feb.

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Greenspan speaks

Greenspan: Expansion has

no more "broad-based"

RECENT QUARTERS

LEAVING

N'T BROKE
Greenspan is
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meeting, short-term rates will be inching closer to levels where some Fed officials might even consider taking a break from their rate-hiking campaign. "Interest rates clearly are not at restrictive levels," Minneapolis Federal Reserve Bank President Gary H. Stern said in a speech on Jan. 18. But, he added, "if we keep inflation low, I don't see any reason why interest rates should reach particularly high levels."

Buttressing Greenspan's view: Despite the steady rise in short-term rates, financial markets have stayed calm. Stock prices have risen, and bond yields are actually lower than when the Fed started raising rates in June (page 29).

In previous expansions, falling long-bond rates often signaled the market's concern that the economy might be weakening. That's unlikely to be the case this time. The economy, in fact, looks pretty good. Business has shrugged off a jump in oil prices, and gross domestic product looks set to grow 3.5% to 4% in 2005, Fed officials say. Although inflation has crept up some, it remains well-contained. Excluding volatile food and energy costs, core consumer prices rose just 2.2% in 2004. "We haven't seen any worrying rise in inflation at this point," Fed Governor Edward M. Gramlich told reporters on Jan. 12.

While there are differences at the Fed over the risks of inflation, central bank officials insist that it would be wrong to exaggerate them. Most of the Dec. 14 meeting was in fact spent discussing the Fed's growing confidence in the durability of the economic upswing. But that conclusion caused little divergence among policymakers and was given short shrift in the minutes. As a result, more of those were devoted to the discussion of inflation, magnifying the importance of those differences. That emphasis may also have led some investors to conclude that the Fed is more worried about a rise in inflation than appears to be the case, Fed insiders say.

What's critical is what Greenspan thinks. While his influence may dim the closer he gets to stepping down next January, Fed insiders say he remains first among equals. Throughout his 18-year Fed career, Greenspan has focused like a laser on productivity growth, labor costs, and profit margins in trying to determine the



At some point the measured language will come out of the Fed statement. There would be a pretty vigorous reaction [by the Fed] should we see inflation threaten to move to sustainably higher rate."

—William Poole, President
Federal Reserve Bank of St. Louis

outlook for inflation. Now is no different.

The message from those key indicators? Inflationary pressures may be building, but gradually. Yes, productivity growth has slowed to a 1.8% annu-

alized pace in the third quarter of last year, the latest period for which data are available. But that slowdown is from extremely strong levels that Greenspan long thought were unsustainable. Excluding farming, productivity grew at a 4.4% clip in 2002 and 2003, a pace that puts even the New Economy of the 1990s boom to shame.

And sure, unit labor costs have turned up as productivity growth has slowed. But that's after costs fell in both 2002 and 2003, the first back-to-back yearly decline since the early 1960s. Labor compensation—wages and benefits combined—is growing steadily, at around 4% annually, and shows scant signs of accelerating. That's not a big surprise given the modest jobs growth so far in this recovery.

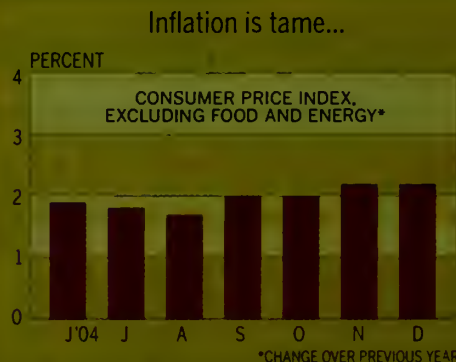
Profit margins, meanwhile, look to be leveling off after sharp jumps last year. It

was that rise in profit margins Greenspan identified as the culprit behind last spring's pickup in inflation. But as firms gain confidence and become more aggressive, competition for market share will heat up. That will limit companies' ability to pass on their added costs to customers. The likely result: a squeeze on margins and a cap, at least temporarily, on inflation. And that seems to be the message from the monthly survey of small companies by the National Federation of Independent Business. It shows that pricing power peaked in June of last year.

CLOSER TO EQUILIBRIUM

OF COURSE, INFLATION risks will look a lot different to Greenspan if the central bank hadn't already replenished its monetary juice from the economy. When the Fed began tightening credit last June, policymakers said they wanted to raise ultralow interest rates back to equilibrium levels where monetary policy is neither stimulating nor holding back the economy. What equilibrium level is, though, isn't clear. Greenspan has said he'll know it when he gets there.

THREE REASONS TO STAY THE COURSE



Data: Labor Dept., Bloomberg Financial Markets, Commerce Dept., Macroeconomic Advisers



—By Rich Miller in Washington

S&P 500 INDEX

JAN. 14. '05

The Mystery of the Sleeping Long Bonds

-By Rich Miller in Washington

THE STAT

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BASIS POINTS

Data: $3 \times 5 \times 10$

growth could be setting the market and the economy up for an abrupt adjustment. Unfortunately, not even the Fed knows for sure which causes dominate—or how they'll play out. ■

COMMENTARY

BY PETER COY

That Trade Deficit Is No Debacle

As long as growth keeps surging, the U.S. will remain a magnet for foreign capital.

THE LATEST REPORT on the U.S. trade deficit was a headline event. In November, imports exceeded exports by a record \$60 billion—more than a million bucks for each minute of the month. The gap was up 32% from January, surprising analysts who had expected the falling dollar to help shrink the gap. The trade deficit now stands at around 6% of gross domestic product, the highest level ever.

How worried should we be? To many businesspeople and politicians, the trade deficit shows the U.S. is living beyond its means and stealing from the living standards of future generations. They worry that foreign creditors, by propping up the dollar and allowing Americans to overconsume, are giving the U.S. the rope to hang itself. They fear an abrupt plunge of the dollar could boost inflation, devastate the stock market, and force the Federal Reserve to jack up interest rates to defend the currency. Says Morgan Stanley Chief Economist Stephen S. Roach: "We're guilty of taking excess consumption to an entirely different plateau than any leading modern economy has ever seen."

Streaking Ahead

BUT THERE'S A different way to look at the trade deficit that's much less frightening. In this view, U.S. policymakers have properly stayed focused on what really matters: fostering strong economic growth to increase prosperity. At the moment, the U.S. is growing faster than many of its trading partners in Europe and Japan, so imports are rising faster than exports, and the trade gap is growing. But fighting that trend—say, by slowing domestic growth—would be pure folly. Robert Z. Lawrence, a trade economist at Harvard University's John F. Kennedy School of Government, is among those who warn against focusing on the trade deficit as a problem unto itself. Says Lawrence: "I'm more into getting our fundamental fiscal and monetary policies right."

Sure, the November trade deficit was a shocker: It set a record when it seemed the gap should be shrinking. But

Lawrence says that's no surprise. His research shows it takes up to three years for a cheaper dollar to curb the deficit. The dollar peaked against other currencies in February and only began dropping in earnest a year later. As the dollar of this plunge filters through the economy, Lawrence expects an increase in exports in the months ahead, restraining the trade deficit.

Promoting prosperity at home makes the U.S. a magnet for the world's capital. Given its strong growth prospects, investors from other nations want to own American stocks, factories, real estate, and the like. This inflow of foreign money, in turn, enables Americans to purchase foreign goods. Over the years, the U.S. has shifted toward the production of knowledge-oriented goods and services, from biotech to movies, while relying on other countries to supply manufactured products. Yes, the U.S. buys a lot from overseas, but it can afford to—as long as the return on investments in the U.S. remains high enough to continue attracting foreign capital.

Certainly, there are good reasons for the world's investors to put money in America. The U.S. has a unmatched record of innovation. Meanwhile, Western Europe and Japan are stuck with perennially slow growth and aging populations. Chinese and Indians can hedge their bets by putting some of their money in the U.S., which is safe and stable. And what may appear from the official savings statistics that the U.S. is living beyond its means is actually investing heavily in the future in the form of education and research and development (BW—Jan. 17). If Americans were selling off their inheritance to pay for a spending spree, you would expect it to show up in the statistics. Far from it: The net worth of Americans has continued to rise in spite of the transfer of some assets abroad.

While pundits wring their hands about the coming dollar crisis, foreigners with real money on the sidelines seem less concerned. They're putting their euros, yen, and dollars in the U.S. True, for several months last year, much of the investment inflow was from Asian central banks, including those of China and Japan, which seemed to be trying to prop up the dollar so Americans could afford to buy their countries' products. Lately, though, the central banks have backed off, and private investors have come to the fore. The Treasury Department announced on Jan. 18 that private foreign investors bought \$72 billion of long-term domestic assets from Americans in November, while official foreign organizations bought a modest \$28 billion worth. The private flows alone were

WIDENING GAP

Since January, a 32% spike



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than enough to finance the \$60 billion trade deficit. And the dollar rallied on the news to its highest level in two months against the euro. Says Daniel Griswold, director of the Center for Trade Policy Studies at the libertarian Cato Institute: "There's no reason to think that foreigners are going to wake up one day and say: 'I'm going to pull all of my money out of the U.S.'"

Deciding how scary the deficit really is has big implications for real-world policy. Those most concerned about the trade gap favor the most drastic actions. The AFL-CIO, for example, wants to slow down future free-trade agreements and favors strong action to get China to revalue its currency by 40%. Many mainstream economists focus on increasing the national savings rate by shrinking the federal budget deficit and getting households to sock away more of their paychecks. Morgan Stanley's Roach goes further than most, arguing that the Federal Reserve should raise interest rates to cool off households' financial speculation.

Empty Jawboning

BUT SUCH CURES range from impractical to counterproductive. China won't revalue the yuan by 40% no matter how much the U.S. jawbones, and threats of sanctions against China would only risk a trade war. As for increasing the national savings rate, it's hardly a cure-all. There's little support in economic research for the view that low savings rates are damaging. Proof: The U.S. is growing handsomely with a low savings rate, while Germany has been dogged by years of slow growth in spite of abundant savings. And Fed rate hikes? Sure, they make sense—but not to the point where they choke off consumer demand and risk a recession.

President George W. Bush, for one, seems to side with the view that promoting growth matters more than targeting trade deficits. He told *USA Today* in a recent interview that "the best way to deal with the trade deficit is to make sure that America is... the best place in the world to do business." The Administration has wisely resisted calls to lobby for a lower dollar, while avoiding the equally misbegotten course of trying to prop it up above its natural level.

The trade deficit may look scary, but the U.S. would be wise not to overreact to it. Get the big things right—such as healthy domestic growth—and the rest will take care of itself. ■

ENTERTAINMENT

INTERACTIVE TV: WHAT'S IN THE CARDS?

It's electronics companies vs. the cable giants in a battle over digital services

WELCOME TO THE LATEST BATTLE for control of your TV. First it was the satellite companies against the cable guys in a fight for subscribers. Then digital video recorders (DVRs) like TiVo invaded the living room. Before long, telecom companies jumped in, threatening to snatch viewers away from both cable and satellite providers with new ways to deliver video and other content to the electronic hearth. As if that weren't enough, a battle is looming between cable operators and makers of TVs, video recorders, and other consumer

The fight is over a seemingly innocuous, wafer-thin device called a CableCard that unscrambles digital video images. The cable industry worries that the technology will siphon off its new premium services such as video on demand. Indeed, big bucks are at stake: At its core, the fight over CableCards gets down to whose logo you will see when you turn on your TV and who you'll pay for programming you order up under that brand. Here's a primer:

How do CableCards work?

CableCards slip into a built-in slot on the newer digital TVs as well as on upcoming DVR models from TiVo Inc. Hewlett-Packard also has a similar product in the works. With a CableCard, you can get rid of your cable box and plug your cable directly into your TV or recorder box.

How will CableCards change the way you view television?

Viewers will have more choices both in the way they view programming and the equipment they're able to hook up to their cable systems. Rather than get their on-screen programming guide from their cable company, the guide will come with the TV you buy or the recording device you plug into it. LG Electronics Inc., for instance, just unveiled a big-screen, cable-ready set with its own digital video recorder included. South Korea's Humax

Co. also announced that it will soon begin selling a liquid-crystal display with built-in TiVo service. The company would then simply provide a pipe that carries the video signal.

Other new devices may soon allow you to bypass the video-on-demand interactive services of the cable-TV companies and order downloads directly from the Internet. TiVo, for example, is about to launch a service allowing subscribers to download movies over the Internet. Netflix, the popular DVD-by-mail service,

Can anyone get a CableCard?

Yes. Under FCC regulations, all cable companies must provide CableCards to any consumer who wants one. That's been the case since several years ago Congress decided that consumers should be able to buy programming directly from retailers such as Best Buy Co. The goal: to promote greater competition and innovation in these devices. Satellite gear has been equipped with descramblers for years. But few cable consumers are aware that similar cards are available for their services, largely because the cable companies aren't actively promoting the device.

So why are cable and consumer-electronic companies at loggerheads? TV makers began producing Cable



sets last July, but so far just a fraction of customers have asked for the cards. Consumer-electronics makers accuse the cable companies of failing to tell their customers they can get the cards and of bad-mouthing the technology when customers balk. Most cable companies do rent the cards for about \$1.50 per month, but they say consumers are turned off by them. Not all of the new retail devices come with the cards. That has prompted negative responses from TiVo, Sharp Corp., and other consumer-electronics makers. They complain that the cable companies are simply trying to protect themselves from the loss of revenue that would occur if card technology takes off.

cable companies will still provide broadband pipe into the house, and if subscribers still must pay for that pipe, are they worried?

Customers would continue to pay for service. But the cable giants would add additional revenue if a slew of upcom-

ing interactive services are a hit with consumers. Indeed, most of the growth for cable companies is expected to come from video on demand and other interactive services such as downloading music and buying theater tickets. Rather than view programming through the filter of, say, a Time Warner or Comcast program guide, or order up pay-per-view movies from one of those providers, viewers could get their premium programming directly through a TiVo DVR or an HP media hub, both of which will soon let viewers download directly from the Net. To keep customers from switching, Comcast and others have been rolling out their own DVR services.

So just how much business is at stake?

Interactive services in the U.S. have mostly been limited to pay per view and digital video recording. But consumer-electronics think tank TDG Research, a division of Diffusion Group, estimates that content delivered over the Net will become a \$17 billion annual global market by 2010,

up from virtually nothing today.

With Verizon Communications, SBC Communications, and BellSouth all scheduled to roll out competing interactive services beginning this year, and the DirecTV satellite service launching its own advanced interactive play, cable companies now face threats that did not exist when the lawmakers set their rules. "Are we worried? Heck yes, we're worried," says Bob Blackburn, director of video engineering at Adelphia Communications Corp., the nation's sixth-largest cable provider. "But we intend to be prepared for them when they come."

Why is TiVo so central in this fight?

TiVo, struggling to survive, wants to become an alternative to cable boxes. The DVR company has seen robust growth in the past year, to nearly 3 million subscribers. But about two-thirds of its business has come from its deal with Rupert Murdoch's DirecTV Group Inc. to provide integrated digital DVRs and satellite boxes. The exclusive relationship is coming to an end this year, however, as a sister company to DirecTV begins deploying its own recorder boxes. Moreover, TiVo recently backed out of talks to do deals with cable providers to co-brand services, since company execs were reluctant to compromise on TiVo's rich offering of features. So TiVo's hopes now rely largely on striking deals with content providers, such as its agreement with Netflix Inc.

When will this fight get resolved?

Electronics makers want cable operators to put CableCards in their leased boxes by 2006, as required by the FCC. They say if all sides include the technology, consumers would see even better services roll out more quickly, and equipment costs would fall sharply. Cable companies want to extend the deadline or be exempted from adding the card technology, arguing it would add unnecessary costs to change technology that already works. The FCC has said it will make a decision later this month about whether cable companies must stick to the July, 2006, deadline. A win for the cable companies would preserve the status quo a while longer and could sound the death knell of TiVo. A win for the consumer-electronics companies will be a blow to cable's growth prospects and may give TiVo a new lease on life. More important, it could speed a slew of cool new consumer-electronics gear to a store near you. ■

—By Cliff Edwards in San Mateo, Calif., with Ronald Grover in Los Angeles and Catherine Yang in Washington

CONSUMER ELECTRONICS

MOTOROLA SHARPENS THE RAZR EDGE

It's gaining ground in the handset market, but will the good news be more than a blip?

NOT SINCE MOTOROLA Inc. released the StarTac, the black flip-phone that sent shudders of fear through the cellular industry in 1996, has the Schaumburg (Ill.) communications company been this hot. The industry's killer handset of the moment: Motorola's ultra-sleek Razr V3. For two years, top designers labored in secret to develop a credit-card-size phone packed with all the current doodads—camera, video playback, and MP3 player. When CEO Edward J. Zander got his first peek last spring, he recalls thinking: "This is an iconic product." He pushed his crew to make as many as possible.

Now the industry is paying attention once again. Since the Razr V3 hit store shelves in November, Motorola has shipped an estimated 750,000 of the \$500 phones—three times more than Zander initially expected. And *BusinessWeek* has learned that the company is hard at work on a whole family of Razr-like phones in various shapes and col-

ors—including the Sliver, a candy-bar-shaped Razr—to be announced later this year.

The Razr, part of what JPMorgan Chase & Co. analyst Ehud Gelblum calls "the company's best lineup of phones in recent history," helped Motorola sail to its strongest quarter since Zander took over from former CEO Christopher B. Galvin a year ago. The company posted \$654 million in earnings on record sales of \$8.8 billion in the fourth quarter—a 27% jump over the previous year's sales. For the full year, Motorola earned \$1.5 billion on \$31.3 billion in revenue. Says Zander: "We showed what Motorola innovation was all about."

Can Motorola keep it up? Despite the good news, shares tumbled 7%, to \$16.20, the day after the announcement. Clearly worried that Motorola might slip into its old habit of up and down performance, investors were reacting to a possible plateau in profit margins and soft

guidance for the first quarter: 17¢ a share, below Wall Street's 20¢ sus. The pessimism may be too much: Over the last four quarters, Motorola has beaten analysts' estimates. Moreover, with the stock still up since Zander took the helm, management may simply be taking profits. Says Zander: "I don't know how many quarters we're out of the penalty box."

He'll likely get his answer by next year when a host of new "wow" products will be on show. Motorola can sustain its momentum. By then Motorola plans to release several more phones, including the E815, which plays TV-quality video, and the MPX, a smart phone with a clamshell design.

The key to continued strength? This is not the old, sluggish Motorola. Zander has intensified efforts to overhaul the company's supply chain. Factories now do a better job estimating customer orders and delivering product on time. Better yet, Motorola has finally cracked the common chassis parts that enable it to produce different phones quickly.

That's a big reason why Motorola delivered 20 new models in the fourth quarter and bumped up its market share from 13.5% to 16.6%, reclaiming the No. 1 spot from Samsung.

Still, Zander faces plenty of challenges. Motorola badly needs to start shipping more phones to Verizon Wireless and Sprint. The market for CDMA phones, which both carriers use, could grow much as three times faster than the overall phone market, according to Stratistics & Poor's analyst Kenneth M. Leon, as carriers roll out speedy new networks.

require sophisticated CDMA phones, which haven't been Motorola's strong suit. But its rivals suggest it's making progress.

Boosting margins will also be critical. Nokia reports phenomenal operating margins in the teens, vs. Motorola's 10.5%. Zander says shared platforms and a focus on avoiding inventory backlogs will help.

Zander has put Motorola on solid ground. Now he needs more hits such as the Razr to prove this turnaround has staying power. ■

—By Roger O. Coe
in Chicago



ZANDER A vision of "seamless mobility"



HARD CELL

Motorola's cool new cell phones should sell well, though some may be late to the market

1 RAZR V3 Since debuting in November, the ultrathin fashion phone has been a hot seller, generating buzz and raising the design bar

2 MPX The Windows smart phone, which should hit stores in a couple of months, folds like a taco, handles work documents and e-mail, and boasts a flash camera

3 E815 It's not first, but when it debuts by June the new model will be the sleekest phone to offer TV-like video and speedy music downloads

MANAGEMENT

SHAKING UP INTEL'S INSIDES

How its incoming CEO intends to make the chipmaker more market-focused

LONG BEFORE ANNOUNCING a sweeping reorganization of Intel Corp.'s operating divisions on Jan. 17, CEO-designate Paul S. Otellini had been telling the world about a major shift in the chipmaker's strategy. Gone were the days, he said, when the company could get by with a myopic focus on microprocessor technology. Intel would instead focus more on putting together chips and software into integrated platforms designed to perform specific tasks, such as showing movies on PCs or keeping corporate e-mail servers virus-free. "For the first time in decades of the company, we're designing products that aren't designed to be used together and they weren't marketed together," Otellini told *BusinessWeek* in November.

Now he's making it clear to employees that, under his leadership, Intel is truly entering a new era. Otellini, who officially takes the helm on May 18, will be the first CEO of the company without an engineering degree at a company where engineers have reigned supreme.

He believes that to keep Intel growing, every idea and technical solution should be focused on meeting customers' needs from the outset. So rather than relying on its engineering prowess, Intel's reorganization will bring together engineers, software writers, and marketers into five market-focused units: corporate computing, the digital home, mobile computing, health care, and channel products—PCs for small manufacturers.

The reorganization is not without challenges, but if Otellini succeeds it will amount to a revolution. For years, Intel

Intel's Makeover

The challenges ahead:

LEADERSHIP Two people apiece will run two of the biggest groups. Figuring out who's in charge could be a problem.

TEAMWORK Long-dominant hardware engineers will have to learn to work more closely with marketers and software engineers.

COMPENSATION Traditionally, Intel has rewarded individuals for performance. Now teams will be judged as a whole.

OTELLINI He's the first Intel boss who isn't a trained engineer

has built one-size-fits-all processors, then expected customers to adopt them in various markets. But tech companies increasingly are being asked to deliver solutions that respond to the end user's demands. Corporations, for instance, are looking to prevent their systems from crashing, but employees frequent sites that contain viruses or spyware. Intel has responded by developing chips and software that quarantine these PCs and limit the damage.

TANDEM APPROACH

OTELLINI'S REORGANIZATION is supposed to ensure that such product tailoring becomes part of Intel's DNA. How will it work? The company's Centrino wireless notebook platform provides some clues. Intel first determined consumers wanted a powerful notebook with decent battery life that connected wirelessly to the Net. Armed with this knowledge, engineers and software writers designed a package of chips that would do that. Later, engineers and marketing people joined forces to create advertising that would persuade consumers to pay a premium for Centrino-powered notebooks. It worked: As of December, Intel had 87% of the notebook PC market, says Mercury Research.

But imposing such a management structure across the company won't be easy. For one thing, Otellini has taken the unusual step of putting two execs apiece in charge of the two biggest groups, mobility and corporate computing. Intel has used this "two-men-in-a-box" approach before, but it will be particularly tricky under the new structure. Each unit will be responsible for several market segments; for example, the mobility unit will build platforms for notebooks, handhelds, and cell phones. So divvying up each co-chief's duties will be a challenge. Getting that right is crucial or the rank and file won't know who to report to.

The new regime will cause a jolt to the culture. For decades, employees have been compensated for their own work. Now teams will be judged as a whole. Engineers, long the top dogs, may resist working with others. "It's like saying to a baseball player, 'Gee, we're deciding to play pro football,'" says Edward E. Lawler, a professor at USC's Marshall School of Business. "All of a sudden, the rules of the game are very different."

Otellini has begun to put the pieces in place. Now he'll need the teamwork of his people to pull it off. ■

—By Cliff Edwards in San Mateo, Calif.

COMMENTARY

BY MICHAEL ARNDT

Needed: More Bite to Fight Fat

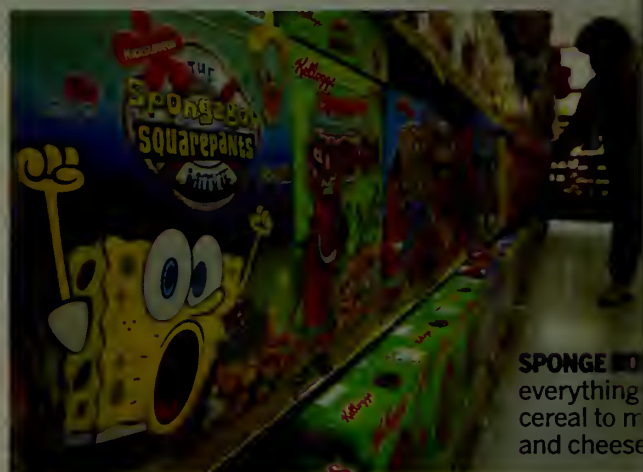
Without stronger federal guidelines, foodmakers will keep pushing junk

FORGET THE ATKINS DIET, the South Beach Diet, and other low-carb regimens. The latest thing in food is simply eating less. Says who? No less than the federal government, which told the public in its new dietary guideline that the secret to better health is to count calories and exercise. The Jan. 12 advice easily made its way into newscasts and the nation's newspapers. "Do you want to look better? Do you want to feel better?" asked outgoing Health & Human Services Secretary Tommy G. Thompson. "You lower your calorie intake, you lower your fats, your carbs, you eat more fruits and vegetables."

So what's the food industry's response? Yawn. While some giants already have begun improving the quality of processed foods—PepsiCo Inc. got rid of unhealthy trans fats in its Frito Lay snacks in 2003—most will pretty much continue pushing the same old stuff. Little wonder. These foods may be bad for you, but many people like to eat them. The new guidelines are unlikely to change that, if the past is any guide. "People simply don't pay any attention to them," says Kelly D. Brownell, director of Yale University's Center for Eating & Weight Disorders and author of *Food Fight: The Inside Story of the Food Industry, America's Obesity Crisis, and What We Can Do About It*.

In large part that's because the suggestions are only that—suggestions. Moreover, the industry makes most of its money selling products packed with fat or sugar, or both, so it has little incentive to initiate changes that consumers aren't clamoring for. The government has done little to single out foods that consumers should shun, and it isn't spending much to get the word out. "The real nutritional education in this country comes from the food industry," says Brownell. "And nearly every one of their lessons is bad."

Because they're so vague, the eating recommendations aren't likely to help class-action lawyers looking to hold the food industry responsible for America's rise in obesity, either. Many attorneys who helped bring cigarette makers to their knees boasted that they would do the same thing to food companies. But ever since an obesity suit against McDonald's Corp. was tossed out in 2003, plaintiffs' lawyers have been quiet. Bringing a class action today requires serious venue shopping. The industry has won im-



munity or reduced liability from obesity suits in 14 states including Colorado, Florida, Michigan, Ohio, and Washington. "We would take some real fast footwork on the part of attorneys these guidelines in their favor," says Dr. David L. Katz, director of Yale's Prevention Research Center and author of *The Way We Eat*.

Of course, some food companies see a payoff from better products. Food is a notoriously slow-growth business: sales increasing only about as fast as the population, or percentage points a year. To achieve better-than-ordinary

results, companies need breakout products. No category is hotter today than health food. Sales of organic products, for instance, have been rising by almost 20% a year since 1990, to an estimated \$12.25 billion in 2004. To be sure, that's a sliver of the total market. But as consumers turn away from foods with trans fats—the partially hydrogenated oils that lead to clogged arteries—there's clearly more room catering to that niche.

Much of the industry's health initiative appears cosmetic, however. While McDonald's may add more veggies to diet-conscious moms, its restaurants still make fries in vats of trans fats, despite promising in 2002 to switch to a healthier oil.

Likewise, Kraft Foods Inc. won public-relations points by announcing it would quit hawking junk food on TV to kids under 12, just as the government issued its dietary guidelines. But it is still slapping SpongeBob SquarePants and other characters on everything from macaroni and cheese to fruit snacks. The government can set recommendations, but unless they have real teeth, foodmakers will continue to help Americans stuff their faces.

—With Adrienne Carter in Chicago, Catherine... in New York, and bureau re

THE STAT

31%

Share of U.S. adults who are obese,* up from 13% in 1962

*as of 2002

Data: Centers for Disease Control & Prevention

Where IP and telecom unite.
Where security is offensive, not defensive.
Where e-commerce is safe commerce.
Where content is mobile and personal.
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COMMENTARY

BY LOUIS LAVELLE

A Simple Way to Make Boards Behave

Requiring directors to win a majority of votes would give shareholders more s

EIGHTEEN MONTHS ago, the Securities & Exchange Commission embarked on a plan to give shareholders the right to nominate their own director candidates. The aim was to make it easier to oust bad directors and make boards more responsive. But after intense opposition from business groups, the once-revolutionary reform has bogged down at the

SEC. And even if it survives, the proposal has been transformed into a convoluted process that's unlikely to accomplish its goal. The bottom line: Showing a bad director the door would take at least 18 months, if it happens at all. Says Joanne T. Medero, general counsel for Barclays Global Investors: "We think the proposal really needed more thought."

There's a far better way, and it's gaining credence in corporate-governance circles: requiring directors to win a majority of votes. It's simpler and faster, allowing shareholders to remove bad directors at each annual meeting. It keeps control over nominations in directors' hands, preventing special interests from hijacking the process. In coming months, investors at as many as 100 companies—including Merrill Lynch, Gannett, and Motorola—will vote on nonbinding shareholder resolutions urging those companies to adopt majority voting. It's an idea that deserves serious consideration. Says Ann Yerger, executive director of the Council of Institutional Investors: "It would make boards think even harder about their duties and responsibilities."

Currently most U.S. companies only require directors to win a plurality, which means that uncontested board nominees nearly always keep their seats even when most shareholders want them out. To cite one recent example: Four directors at Federated Department Stores continue to serve, despite winning support from only 39% to 43% of investors at the annual meeting last May. With limited incentive to address shareholder concerns, many boards routinely ignore shareholder resolutions even when they win.

The proposal the SEC is considering isn't much. Shareholders would get to nominate director candidates only after a massive vote against a sitting director, and the company fails to address investors' concerns. The plan has been stalled at the SEC because Chairman William H. Donaldson has been unable to craft a compromise that will win the backing of a majority of his fellow commissioners. The SEC is sympathetic to the concerns raised by many in Corporate America that the rule would hand control of the nomination process to special interests, such as labor, whose agenda often runs counter to a company's interests.

With majority voting, that wouldn't be a problem. Directors would continue to control board nominations, but candidates

would be required to win a majority of votes cast. If they don't, the board, under one version, would be required to put up a new nominee subject to investor approval. Another option would require boards to decide the fate of directors; alternatively, it would allow them to stay on only if they are subject to onerous disclosure requirements. Susan Ellen, chairwoman-elect of the Society of Corporate Secretaries & Compliance Professionals, called the first version "a brilliant compromise."

Still, many companies remain skeptical. At Bristol-Myers Squibb Co., a majority vote resolution won 7.4% of votes cast early last year, and it has been submitted again for the annual meeting in May by the United Brotherhood of Carpenters and Joiners of America, a major advocate of majority voting. The board is urging shareholders to reject the proposal. Bristol calls it "unworkable," arguing that filling vacancies created by majority voting would cause instability



Bad directors could be voted out at each annual meeting

that qualified people would be deterred from serving.

Those fears may be overstated. In reality, only directors deemed to have been particularly bad stewards would likely be ousted. The main benefit of bringing majority vote to the boardroom would be its value as a deterrent. The future of individual directors could hang in the balance in every decision made—a recipe for accountability if ever there was one. ■



*Trends in Proprietary Information Loss Survey (ASIS 2002) ©2004 Sharp Electronics Corporation

How secure is your digital information?

Protect your information with the Data Security Kit from Sharp. Financial facts, personnel records, customer lists: networked copiers/printers process sensitive information every day. Unfortunately, their hard drives can also be accessed via the network, contributing to \$60 billion worth of information stolen every year.* To protect this weak link in your

corporate security, we've created our Data Security Kit. It's the first copier and printer protection to be validated by Common Criteria, a government-sponsored program, and it's available only with our Digital IMAGER™ series of copiers/printers. Sharp's Data Security Kit. Enhanced information protection at your fingertips. sharpusa.com/security



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EDITED BY MONICA GAGNIER

HEADLINER

STEPHEN COOPER



DOCTOR DOUGHNUT

When restructuring specialist **Stephen Cooper** gets a call for help, it's often to guide a company into—or out of—bankruptcy. That was the case at his latest job as CEO of Enron. But with his next assignment—CEO of Krispy Kreme Doughnuts, a position Cooper accepted on Jan. 18—the question is whether he's arriving in time to keep the troubled doughnut chain out of Chapter 11. Investors think so—Krispy Kreme's shares rose 10%, to \$9.61—and so does Cooper. "This company still has pretty good cash flow and tremendous brand equity," he says.

Cooper's first task: Persuading banks not to call in a \$150 million loan, although Krispy Kreme is in technical default. And analysts say Cooper may have to shutter as many as 70 of the chain's 400 restaurants, remnants of a disastrous expansion spree by outgoing CEO Scott Livengood. But ultimately, Cooper will be judged on whether he can accomplish a turnaround without a trip to the courthouse.

—Dean Foust

IT JUST WASN'T GM'S YEAR

General Motors had mostly bad news when it reported earnings on Jan. 19. Slower sales in the U.S. and a \$742 million loss from its troubled European business cut the carmaker's 2004 earnings by \$200 million, to \$3.7 billion, or \$6.51 a share. In 2003, GM earned \$3.8 billion, or \$7.14 a share. Only record profits of \$2.9 billion from the auto giant's **GMAC** finance arm in 2004 kept profits from really tanking, even as revenues rose 5%, to \$193 billion. Things will only get worse. GM Vice-Chairman and Chief Financial Officer John Devine says a \$1 billion jump in health-care costs will trim 2005 profits—to between \$2.3 billion and \$2.9 billion—renewing concerns that agencies will drop GM's credit rating to junk status. That would raise GMAC's borrowing costs, making it tough to loan money at competitive rates. So it may carve out its mortgage-lending operations as a separate, wholly owned entity to protect the business from a credit downgrade.

NEW VC IN THE VALLEY



Bill Joy, co-founder and former chief scientist at **Sun Microsystems**, has joined Silicon Valley venture-capital firm **Kleiner Perkins Caufield &**

Byers as a partner. Joy arrives at a time when VC firms are looking beyond traditional information technology for investment ideas. He will scour for business plans not only in computing but also in fields like alternative energy and new materials. "Science and technology are at a point right now where those kinds of things are happening," he says. Joy has already helped finance several startups on his own, and he has worked with Kleiner Perkins since the firm funded Sun in 1982.

CHARTER GOES CEO HUNTING

After losing more than \$6 billion in the cable-TV business, billionaire Paul Allen is switching managers at **Charter Communications**. Unhappy over continued losses and subscriber defections to satellite, the Charter board and CEO Carl Vogel "mutually" agreed that Vogel will leave the nation's fourth-largest cable company with a year left on his four-year contract. Vogel gets high marks for restructuring Charter's still-hefty \$18 billion debt load. But he has been criticized for poor customer service and a slow rollout of new products like video on demand and Internet phone service. Charter named former **Cablevision Systems** COO Robert May interim CEO while it seeks a permanent replacement.

ABBOTT IS IN THE PINK

Abbott Laboratories proved there's still good money to be made in the drug game. The Abbott Park (Ill.) company said on Jan. 18 that fourth-quarter earnings rose 3%, to \$975 million, as sales grew

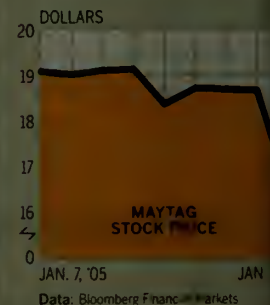
15.5%, to \$5.65 billion. Moreover, 2003 numbers included results from its hospital products unit sold off last year as **Hospira**. It got help from two drug sales in 2005: Humira, injectable prescription rheumatoid arthritis, and pain medication Mobic.

ET CETERA...

- » **Ex-ImClone Systems** CEO Samuel Waksal settled in trading charges without admitting or denying guilt.
- » Growth in online ads drove **Yahoo!**'s fourth-quarter profits up nearly 500%.
- » **Fannie Mae** cut its dividend in half to help close its cash shortfall.

CLOSING BELLS

Maytag shares were hung out to dry on Jan. 19 after Best Buy said it will no longer carry household appliances made by the Newton (Iowa) company. The big box retailer says its customers prefer other brands. Maytag's stock tumbled 10% to close at \$16.73.



alcohol in excess (to a level of intoxication) with Cialis. This combination may increase your chances of getting dizzy or lowering your blood pressure. Cialis does not protect a man or his partner from sexually transmitted diseases, including HIV. The most common side effects with Cialis were headache and upset stomach. Backache and muscle ache were also reported, sometimes with delayed onset. Most men weren't bothered by the side effects enough to stop taking Cialis. Although a rare occurrence, men who experience an erection for more than 4 hours (priapism) should seek immediate medical attention. Discuss your medical conditions and medications with your doctor to ensure Cialis is right for you and that you are healthy enough for sexual activity.

Cialis® is a registered trademark of Lilly ICOS LLC. Flomax® (tamsulosin HCl) is a registered trademark of its owner.

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*Individual results may vary. Not studied for multiple attempts per dose. In clinical trials, Cialis was shown to improve, up to 36 hours after dosing, the ability of men with ED to have a single successful intercourse attempt.



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Read the Patient Information about CIALIS before you start taking it and again each time you get a refill. There may be new information. You may also find it helpful to share this information with your partner. This leaflet does not take the place of talking with your doctor. You and your doctor should talk about CIALIS when you start taking it and at regular checkups. If you do not understand the information, or have questions, talk with your doctor or pharmacist.

What important information should you know about CIALIS?

CIALIS can cause your blood pressure to drop suddenly to an unsafe level if it is taken with certain other medicines. You could get dizzy, faint, or have a heart attack or stroke.

Do not take CIALIS if you:

- take any medicines called "nitrates."
- use recreational drugs called "poppers" like amyl nitrate and butyl nitrate.
- take medicines called alpha blockers, other than Flomax® (tamsulosin HCl) 0.4 mg daily. (See "Who should not take CIALIS?")

Tell all your healthcare providers that you take CIALIS. If you need emergency medical care for a heart problem, it will be important for your healthcare provider to know when you last took CIALIS.

After taking a single tablet, some of the active ingredient of CIALIS remains in your body for more than 2 days. The active ingredient can remain longer if you have problems with your kidneys or liver, or you are taking certain other medications (see "Can other medications affect CIALIS?").

What is CIALIS?

CIALIS is a prescription medicine taken by mouth for the treatment of erectile dysfunction (ED) in men.

ED is a condition where the penis does not harden and expand when a man is sexually excited, or when he cannot keep an erection. A man who has trouble getting or keeping an erection should see his doctor for help if the condition bothers him. CIALIS may help a man with ED get and keep an erection when he is sexually excited.

CIALIS does not:

- cure ED
- increase a man's sexual desire
- protect a man or his partner from sexually transmitted diseases, including HIV. Speak to your doctor about ways to guard against sexually transmitted diseases.
- serve as a male form of birth control

CIALIS is only for men with ED. CIALIS is not for women or children. CIALIS must be used only under a doctor's care.

How does CIALIS work?

When a man is sexually stimulated, his body's normal physical response is to increase blood flow to his penis. This results in an erection. CIALIS helps increase blood flow to the penis and may help men with ED get and keep an erection satisfactory for sexual activity. Once a man has completed sexual activity, blood flow to his penis decreases, and his erection goes away.

Who can take CIALIS?

Talk to your doctor to decide if CIALIS is right for you.

CIALIS has been shown to be effective in men over the age of 18 years who have erectile dysfunction, including men with diabetes or who have undergone prostatectomy.

Who should not take CIALIS?

Do not take CIALIS if you:

- take any medicines called "nitrates" (See "What important information should you know about CIALIS?"). Nitrates are commonly used to treat angina. Angina is a symptom of heart disease and can cause pain in your chest, jaw, or down your arm.

Medicines called nitrates include nitroglycerin that is found in tablets, sprays, ointments, pastes, or patches. Nitrates can also be found in other medicines such as isosorbide dinitrate or isosorbide mononitrate. Some recreational drugs called "poppers" also contain nitrates, such as amyl nitrate and butyl nitrate. Do not use CIALIS if you are using these drugs. Ask your doctor or pharmacist if you are not sure if any of your medicines are nitrates.

- take medicines called "alpha blockers", other than Flomax® 0.4 mg daily. Alpha blockers are sometimes prescribed for prostate problems or high blood pressure. If CIALIS is taken with alpha blockers other than Flomax® 0.4 mg daily, your blood pressure could suddenly drop to an unsafe level. You could get dizzy and faint.
- you have been told by your healthcare provider to not have sexual activity because of health problems. Sexual activity can put an extra strain on your heart, especially if your heart is already weak from a heart attack or heart disease.
- are allergic to CIALIS or any of its ingredients. The active ingredient in CIALIS is called tadalafil. See the end of this leaflet for a complete list of ingredients.

What should you discuss with your doctor before taking CIALIS?

Before taking CIALIS, tell your doctor about all your medical problems, including if you:

- have heart problems such as angina, heart failure, irregular heartbeats, or have had a heart attack. Ask your doctor if it is safe for you to have sexual activity.
- have low blood pressure or have high blood pressure that is not controlled
- have had a stroke
- have liver problems
- have kidney problems or require dialysis
- have retinitis pigmentosa, a rare genetic (runs in families) eye disease
- have stomach ulcers
- have a bleeding problem
- have a deformed penis shape or Peyronie's disease
- have had an erection that lasted more than 4 hours
- have blood cell problems such as sickle cell anemia, multiple myeloma, or leukemia

Can other medications affect CIALIS?

Tell your doctor about all the medicines you take including prescription medicines, vitamins, and herbal supplements. CIALIS and other medicines can affect each other. Always check with your doctor before starting or stopping any medicine. Especially tell your doctor if you take any of the following:

- medicines called nitrates (See "What important information should you know about CIALIS?")
- medicines called alpha blockers. These include Hytrin® (terazosin HCl), Cardura® (doxazosin mesylate), Minipress® (prazosin HCl) or alfuzosin HCl).
- ritonavir (Norvir®) or indinavir (Crixivan®)
- ketoconazole or itraconazole (such as Nizoral® or Sporanox®)
- erythromycin
- other medicines or treatments for ED

How should you take CIALIS?

Take CIALIS exactly as your doctor prescribes. CIALIS comes in different doses (10 mg, and 20 mg). For most men, the recommended starting dose is 10 mg. CIALIS be taken no more than once a day. Some men can only take a low dose of CIALIS of medical conditions or medicines they take. Your doctor will prescribe the dose for you.

- If you have kidney problems, your doctor may start you on a lower dose of CIALIS.
- If you have kidney or liver problems or you are taking certain medications, your doctor may limit your highest dose of CIALIS to 10 mg and may also limit you to one dose every 48 hours (2 days) or one tablet in 72 hours (3 days).

Take one CIALIS tablet before sexual activity. In some patients, the ability to have sexual activity was improved at 30 minutes after taking CIALIS when compared to a placebo. The ability to have sexual activity was improved up to 36 hours after taking CIALIS compared to a sugar pill. You and your doctor should consider this in deciding when to take CIALIS prior to sexual activity. Some form of sexual stimulation is needed for an erection to happen with CIALIS. CIALIS may be taken with or without meals.

Do not change your dose of CIALIS without talking to your doctor. Your doctor may increase or decrease your dose, depending on how your body reacts to CIALIS.

Do not drink alcohol to excess when taking CIALIS (for example, 5 glasses of whiskey). When taken in excess, alcohol can increase your chances of a headache or getting dizzy, increasing your heart rate, or lowering your blood pressure.

If you take too much CIALIS, call your doctor or emergency room right away.

What are the possible side effects of CIALIS?

The most common side effects with CIALIS are headache, indigestion, back pain, flushing, and stuffy or runny nose. These side effects usually go away within a few hours. Patients who get back pain and muscle aches usually get it 12 to 24 hours after taking CIALIS. Back pain and muscle aches usually go away by themselves within a few hours. Call your doctor if you get a side effect that bothers you or one that will not go away.

CIALIS may uncommonly cause:

- an erection that won't go away (priapism). If you get an erection that lasts more than 4 hours, get medical help right away. Priapism must be treated as soon as possible to prevent lasting damage to your penis including the inability to have erections.
- vision changes, such as seeing a blue tinge to objects or having difficulty telling the difference between the colors blue and green.

These are not all the side effects of CIALIS. For more information, ask your doctor or pharmacist.

How should CIALIS be stored?

- Store CIALIS at room temperature between 59° and 86°F (15° and 30°C).
- Keep CIALIS and all medicines out of the reach of children.

General Information about CIALIS:

Medicines are sometimes prescribed for conditions other than those described in this information leaflet. Do not use CIALIS for a condition for which it was not prescribed. Do not give CIALIS to other people, even if they have the same symptoms that you have. It may harm them.

This leaflet summarizes the most important information about CIALIS. If you need more information, talk with your healthcare provider. You can ask your doctor or pharmacist for information about CIALIS that is written for health professionals.

For more information you can also visit www.cialis.com, or call 1-877-242-5471.

What are the ingredients of CIALIS?

Active Ingredient: tadalafil

Inactive Ingredients: croscarmellose sodium, hydroxypropyl cellulose, hypromellose, iron oxide, lactose monohydrate, magnesium stearate, microcrystalline cellulose, lauryl sulfate, talc, titanium dioxide, and triacetin.

Rx only

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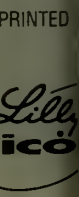
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www.cialis.com

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ED BY MIKE McNAMEE

Why the Clean Air Fight Likely to Be a Draw

ACTIVISTS SEE IT, THE NATION'S basic environmental laws are held up like old-growth trees before a GOP chain saw. Key regulations—from clean-air rules to the Endangered Species Act—coming under attack by staunchly pro-industry Republicans at both ends of Pennsylvania Avenue. “We’ve got a lineup [of

makers] never really seen before in his-
worryes Frank O’Donnell, head of
Air Watch. “There is a great deal of
dial for bad things to happen.”

rolling back enviro regulation may
higher than the GOP expects. Not all
Republicans are signing on. In some cases,
environmental activists are able to use in-
dus’s favorite weapon, the cost-benefit
analysis, to boost regs rather than block
them. And the need to fight global warm-
ing, which is finding growing acceptance
in Corporate America—will undercut
legislators like James M. Inhofe (R-Okla.),
chairman of the Senate Committee on Environ-
& Public Works, who has argued that

is a hoax. The probable
outcome: stalemate. “2005 is
likely to resemble the middle
of World War I: five steps
forward, then back into the
trenches,” says Philip Clapp,
president of the National
Environmental Trust.

With the coming fight
for clean air. After the elec-
tion, the Bush Administra-
tion postponed its so-called
Clean Air interstate rule
(CAIR) requiring cuts in
power-plant emissions. The
administration: to give Congress a
chance to pass a more
comprehensive overhaul of the

Clean Air Act. For enviros, that was a set-
back. Although they consider CAIR’s limits
weak, they like its general approach—
to have rules rather than a legisla-
tion that could reopen and under-
mine existing protections.

But the activists’ nightmare scenario
seems unlikely. While Inhofe has
wanted to move legislation from his Senate
committee by early February, he may not
have the muscle. The GOP has only a two-

vote edge on the panel—and one vote be-
longs to Senator Lincoln D. Chafee (R-R.I.),
who says he won’t support new clean-air
laws unless they limit carbon dioxide emis-
sions, blamed for climate change. Inhofe so
far has refused to do that.

Campaign Promise

IN THE LEGISLATIVE trenches, activists
are also turning the GOP’s insistence on
“sound science” and cost-benefit analysis
back on industry. When the Environmental
Protection Agency set standards for levels
of fine particles in the air, in 1997, business
and its Republican allies attacked the rules
as based on bad science and too costly for

the benefits. But since then,
studies have shown that re-
ducing such pollutants by
cutting power-plant emis-
sions would save lives at a
relatively modest cost. So in
an ironic reversal, it’s the
enviros who are now talking
up cost-benefit analysis—
not the foes of regulation.

Given the hurdles, clean-
air experts say there’s little
chance that the Senate can



TURNED TABLES
Now enviros are
using cost-benefit
arguments

pass a bill before the mid-March
deadline for the Administration’s
CAIR provisions. Although the
White House may delay CAIR further
to boost the legislation’s chances, it
risks being accused of reneging on
George W. Bush’s campaign promise to re-
duce air pollution.

GOP leaders, flush with bigger majorities
in both the House and Senate, won’t stop
their efforts to roll back regs. And the fights
will be intense. But when the smog of war-
fare finally clears, clean air rules and other
key environmental protections probably
will still be standing. ■

—By John Carey

CAPITAL WRAPUP

THE SHORT LIST TO HEAD THE FCC

EVEN THIS EARLY in President
George W. Bush’s second Admin-
istration, telecom watchers are
placing bets on the White House
pick for the next chairman of the
Federal Communications Com-
mission. Current boss **Michael K.
Powell** is widely expected to de-
part this year. On the most-men-
tioned list: former top Texas
utilities regulator **Rebecca A.
Klein**; FCC Commissioner **Kevin J.
Martin**; Assistant Commerce Sec-
retary **Michael D. Gallagher**; and
Washington attorney **Earl Com-
stock**, a former Hill aide to new
Senate Commerce Committee
Chairman **Ted Stevens (R-Alaska)**.
The new FCC chief would face a
full agenda since Stevens is
preparing to rewrite the 1996
Telecommunications Act.

CAN A ‘CODE’ KEEP EURO ARMS SALES SAFE?

WHAT’S THE difference be-
tween an arms embargo and
“code of conduct”? Not much,
according to Europe. The Euros
want to lift the 15-year-old post-
Tiananmen embargo on **China**
later this year so Beijing won’t
be treated as a pariah like **Sudan**
and **Burma**. But Washington
fears that arms sold to China
could be used against the U.S. in
future conflicts, if, say, America
came to the aid of Taiwan.

The Europeans’ solution: a
tough code of conduct for
weapons exports, which they in-
sist would block sales without the
stigma of an embargo. Some
countries, such as **Germany**, al-
ready have stiff laws in place. Eu-
ropeans hope the scheme will
head off a brewing clash with the
Administration over ending the
embargo. But the compromise
may not satisfy the Bush team,
which is skeptical of other na-
tions’ exports curbs—and a Euro-
pean arms industry that is always
hunting for new markets.



GLOBAL AGING

NOW, THE GEEZER GLUT

A surge of graying baby boomers could wreak havoc on the world economy. But there are solutions

JENNY FRANÇOIS DOESN'T have the world's most glamorous job. For 20 years she has commuted 45 minutes to the office of insurer Macif in Agen, France, where she punches data into a computer. But in the not-too-distant future, François and hundreds of millions of people like her in the industrialized world could look back at the early 21st

century as the beginning of the end of a wonderful era, when even average workers could retire in reasonable comfort in their still-vigorous 50s. Thanks to France's pension system, François, 58, is in "pre-retirement." For three years she has worked two days a week and still collects \$1,500 a month—over 70% of her old full-time salary. Her pay will dip only slightly when she reaches 60. "The system is great for me," François says. "I

think it should be every worker's right."

It's already clear that the system is far less generous to future retirees in France and elsewhere. And the message isn't going down easy. Despite a narrow wave of strikes, President Jacques Chirac's government in 2003 enacted new rules requiring people to work longer to qualify for benefits to avert a fiscal crunch. Italy and Germany witnessed massive protests after their govern-

Today's generous pensions in middle age are on the way out

proposed similar measures. In Japan, Prime Minister Junichiro Koizumi still vows to hike pension taxes from around 14% of pay to 18% by 2017 and to slash benefits from 59% of average wages now to 50%. In the U.S. debate is just heating up over President George W. Bush's proposal to let workers park some of their Social Security contributions in investment accounts. Finland, South Korea, Brazil, and Greece all have moved or proposed to trim benefits, raise retirement ages, and hike workers' pension contributions.

The rollback of promises is just a symptom of one of the greatest sociological shifts in history: the graying of the baby-boom generation. Banks of 60-year-olds and older are growing 1.9% a year—60% faster than the rest of the world population. In 1950 there were 12 people aged 15 to 64 to support one person of retirement age. Now the global ratio is nine. That ratio will be only six-to-one by mid-century, predicts the U.N. Population Div. By then the elderly will outnumber children for the first time. Some economists fear that this will lead to bankrupt pensions and lower living standards.

THINNING LABOR POOLS

IT'S WHY EVEN MORE cutbacks in retirement benefits are likely. "I don't even want to think about my children's pension," says Lina Iulita, 72, referring to the Social Security system. In her town of Dormelletto, on the shore of Lake Maggiore, coffee bars are jammed with seniors. The town's over-75 population has doubled since 1971, and there are now fewer children under age 6. Lo-

cal schools and a gym have closed while senior citizens' clubs are flourishing.

The trend has drawn the most attention in Japan, where the working-age population will decline by 0.6% this year, and in Europe. By 2025 the number of people aged 15 to 64 is projected to dwindle by 10.4% in Spain, 10.7% in Germany, 14.8% in Italy, and 15.7% in Japan. But aging is just as dramatic in China—which is expected to have 265 million 65-year-olds by 2020—and in Russia and the Ukraine. Western European employers won't be able to count on the Czech Republic, Hungary, and Poland for big pools of low-cost workers forever: They're aging just as quickly. Within 20 years, South Korea, Thailand, Taiwan, Singapore, and Hong Kong will have a median age of 40. Indonesia, India, Brazil, Mexico, the Philippines, Iran, and Egypt will still boast big, growing pools of workers for two decades. But they're on the same demographic curve and will show the effects of an aging population a generation or two later. "The aging workforce is the biggest economic challenge policymakers will face over the next 20 years," says Monika Queisser, a pension expert at the Organization for Economic Cooperation & Development.

The declining fertility rate and longer life spans that are driving this shift are signs of enormous progress in the 20th century. With rare exceptions—such as Sub-Saharan Africa—birth control and better opportunities for women have lowered birth rates from five or six children per female in the 1950s to as few as one or two today. Over the same period advances in health care have added two decades to the world's average life span, to age 66 now.

For most of the post-war era, the combination of baby booms, healthier populations,

and smaller families amounted to a once-only chance to spur rapid development in nations with the right pro-growth policies. As boomers flooded into the workforce—in the West and Japan, then Latin America and East Asia—they provided the labor for economic take-offs. Then, as they became parents, they had fewer children—and so had more money to spend on goods, services, and education.

But what happens when the baby boom becomes the geezer glut? How this transition is managed could determine the rise and fall of nations and reshape the global economy. Key to growth are hikes in the labor force and productivity. If countries can't maintain the size of their labor forces—by getting older workers to retire later, getting stay-at-home wives to find jobs, or taking in more immigrants—they must boost productivity

to maintain current growth levels. That's a big challenge in Europe, where productivity growth has averaged just 1.3% since 1995.

By these measures, the U.S. is relatively well off. A slightly higher fertility rate and an annual intake of 900,000 legal immigrants should drive the U.S. population from 285 million now to 358 million in 2025. The median age will rise in just three years, to 39, over the next 25 years, before aging really takes off. The U.S. has one of the world's most diversified retirement systems, including Social Security, company pensions, 401(k) savings plans largely invested in stocks, and annuities.

Nations with insolvent pension systems or insufficient private nest eggs, meanwhile, could face "an unprecedented societal crisis," warns OECD Secretary General Donald J. Johnston. Analysts say pension systems in Europe, Asia, and Latin America will start running into serious funding problems in a decade or two. Fur-

A GRAYING PLANET

Aging workers will support many more retirees

RETIREES PER 100 WORKERS*

UNITED STATES



GERMANY



CHINA



JAPAN



RUSSIA



BRAZIL



*RETIREES OVER AGE 65
Data: U.N. Population Div.

Global life span is up 20 years since the '50s

ther down the road, some economists fear that inadequate retiree savings will lead to lower consumption and asset values. McKinsey Global Institute predicts that by 2024, growth of household financial wealth in the U.S., Europe, and Japan will slow from a combined 4.5% annual clip now to 1.3%. That will translate into \$31 trillion less wealth than if the average age were to remain the same. Higher productivity would help, says McKinsey Global Director Diana Farrell. But without radical changes in labor and pension policies, U.S. output per worker "would have to be way north" of the 2.6% McKinsey projects for the next decade, says Farrell, in part because workers will be a smaller part of the population.

Wharton School finance professor Jeremy J. Siegel also thinks productivity won't be enough to offset the rise in the number of retirees. Most pensions now rise with wages. "Wages tend to rise with productivity, and as wages go up people demand higher benefits," he notes. "So you essentially are chasing your tail." Siegel also worries about what will happen when future retirees liquidate their nest eggs en masse. Siegel predicts that only huge capital inflows from emerging markets such as India and China into U.S. stocks, property, and bonds will keep asset values afloat.

A COMING CRISIS IN CHINA

WHETHER SUCH scenarios play out, of course, is anyone's guess. Aging's impact on financial markets isn't well understood. Some argue that only modestly higher productivity will be able to offset demographic shifts (page 48) and that worrymongers use overly pessimistic assumptions of medical costs.

Governments can do plenty to ease the social and economic fallout. From Stockholm to Santiago, policymakers are seeking to boost private savings in stock and bond funds, lure immigrant workers, find cheaper ways to provide elder care, and get companies to hire or retain older workers. On their own, none of these approaches is seen as a practical solution: Germany would have to more than double its annual intake of 185,000 foreign-

ers to make up for fewer births, while immigration to Japan, now just 56,000 a year, would have to leap elevenfold. And slashing pensions enough to guarantee long-term solvency could mean political suicide. But a combination of sensible changes might make a big difference.

Why the sudden attention to a demographic trend that has been obvious for decades? In part, it's because the future is already dawning in many nations. In South Korea and Japan, which have strong cultural aversions to immigration, small factories, construction companies, and health clinics are relying more on "temporary" workers from Vietnam, the Philippines, and Bangladesh. In reality they are becoming permanent second-class citizens. In China's northern industrial belt, state industries are struggling over how to lay off unneeded middle-aged workers when there is no social safety net for support.

Across Europe, meanwhile, baby

lière, chairman of French investment firm Wendel Investisse

A World Economic Forum suggests labor shortages are solvable and Japan could make up for the in working-age citizens by keeping employees from retiring before 65. They also raise the participation of women and people in their mid-20s in the workforce to U.S. levels.

Finland has made the most progress persuading workers to stay on the job. In eight years it has boosted the average retirement age three years, to 59, and employment rate of those aged 55 from 36% to 50%. It will have to do more. The Nordic country's workforce of 2.5 million is aging so fast that experts predict it will shrink by 900,000 by 2050. Serious labor and skill shortages could start crimping growth soon. The Tervasaari mill of UPM, Europe's No. 2 papermaker, 200 of 820 workers



ITALY Some 62% of adults retire by age 55

boomers are retiring in droves—even though the first of this generation won't reach 65 until 2011. Most of Europe's state-funded pension systems encourage early retirement as a way to ease unemployment. Now, 85.5% of adults in France quit work by age 60, and only 1.3% work beyond 65. In Italy, 62% of adults call it quits by age 55. That compares with 47% of people who earn wages or salaries until they are 65 in the U.S. In France, business groups, unions, and the government will begin talks in February aimed at changing early-retirement rules. "We must correct fundamental aspects of that system," says Ernest-Antoine Seil-

will reach retirement age in five years.

So companies such as UPM are slowly raising retirement ages. As of now, workers who retire at 65 now get pensions up to 40% larger than if they quit at 62. Oras Ltd., a maker of electric faucets and valves with 1,300 employees, offers four extra days off a year for workers who are at least 55: Those 60 and older get up to 25 extra days off. "Social leave is profitable for us if early retirement is postponed by even one year," says personnel trainer Merja Helkelä. He says the construction group YIT Group encourages workers over 55 to take less demanding jobs and to act as mentors.

ring up public pensions with private savings plans funded by worker and employer contributions is another avenue nations are exploring. Led by Chile and 11, 12 Latin nations have adopted recent accounts managed by private firms. The upsides can be huge. Mexico has 2.6 million accounts with some \$40 billion in assets. By buying government bonds and helping finance infrastructure, private funds also have injected liquidity into Mexico's capital market.

Privatization alone is no panacea, however. Fund managers charge fees that devour up to 30% of workers' nest eggs. And private funds are leaving many accounts virtually uncovered. Only 38% of all accounts receive monthly deductions from workers, employers, and the government. And 19 million workers have no pensions because they work in the underground economy and pay no social security taxes. "I guess I'll just keep working until my strength runs out," says mechanic Antonio Flores, 31, who supports his wife and daughter on \$125 a month he earns.

Argentina shows what can happen in a managed economy even to those with private pensions. Some 65% of Argentina's 4.5 million workers signed up for private funds since 1994. "The funds promising huge pensions and a perpetual retirement," recalls Maria Rosa Llorca, 49, gazing at a poster of idyllic snow-capped peaks in Patagonia. But the government obliged the funds to invest large thirds of their assets in government bonds that plunged in value in Argentina's financial crisis. Now, Argentina is trying to encourage higher contributions to the funds by offering a debt swap that will help boost the funds' assets. But skeptics are dubious.

Pension and medical reform. Later retirement. Higher productivity. More liberal immigration. Around the world, governments and businesses are searching for creative responses to one of the most profound social transformations ever. It is a mammoth agenda—one that will determine whether the global economy that achieved such astounding progress in the last 20th century will continue to thrive as it matures in the 21st. ■

—By Pete Engardio in New York and
 Matt Lacey in Paris, with Gail Edmondson
 in Helsinki, Ian Rowley in Tokyo, Colin
 Clark in Buenos Aires, and Geri
 Smith in Mexico City



TOILING IN BEIJING China's government pension plan is running a big deficit

CHINA

A Safety Net That's Barely There

Mrs. Wang, a 51-year-old native of Houma, in the province of Shanxi, retired last year after more than two decades as a primary school teacher. Although her former employer, the No. 5 Bureau of the Railways Ministry, pays her a pension of \$60 a month, she's far from happy. Her pension is based on 14 years of employment, not the 24 years she actually taught, because she doesn't have documents from a previous job. The money is barely enough to pay for food, never mind medicines for the occasional cold or other illness. "I'm not satisfied," says Wang, who declined to give her full name.

Wang's predicament is just one example of the tremendous challenges facing a rapidly aging but still relatively poor China. The one-child policy, which prohibits most families from having larger families, is a primary cause of the problem. Many Chinese today face what is known as the "4-2-1 phenomenon." That is, four grandparents and two parents, both from single-child families, must be supported by a single child. About 14% of the mainland's population is over 60—a percentage that will grow to about a quarter in 25 years.

The peak of the crisis will come in 2030, when the number of workers per retiree will fall to two,

down from three now. That's a worrying prospect in a country where per capita income is just \$1,000 a year. "China is still not a rich country even as our population ages," says He Ping, director of the National Institute of Social Insurance.

The government isn't sitting still. In 2000 it began to reform its former pay-as-you-go system, which mostly covered civil servants and state-enterprise workers, in favor of what it hopes will be a more sustainable program of individual accounts. But only 20% of all workers are covered, primarily those in the cities. And there isn't enough money. The national pension system has a shortfall of \$6.2 billion, which could reach \$53.3 billion by 2033, according to the Asian Development Bank. Most provincial pension plans are also in deficit.

To counter the pension crisis, China is likely to boost gradually the retirement age, now 55 for women and 60 for men, to 65 by 2030. It might further loosen the one-child policy. Meanwhile, even those with two

children, like Ms. Wang, worry. "I'm considering finding another job," says Wang. "I might work as a cook for construction workers, but I know that will be very tiring." For now, too many of China's wannabe retirees may have to labor on into their golden years.

—By Dexter Roberts
 in Beijing

VITAL STAT

80%

Portion of Chinese workers without a formal pension.

Data: Asian Development Bank

BusinessWeek online For more on global
 see businessweek.com/extras

CHEN SHUYI/IMAGINECHINA.COM

COMMENTARY

BY MICHAEL J. MANDEL

Productivity Can Make Up the Gap

Demographics will not mean doom if we focus on fostering innovation

THE GHOST OF the Reverend Thomas Malthus is once again haunting the globe—but with a new twist. More than 200 years ago, Malthus predicted that galloping population growth would eventually outrun the available food supply, even in prosperous societies. The result, he argued, would be a widespread fall in living standards.

Today we are seeing the rise of another set of gloomy economists, who might be called “reverse Malthusians.” Rather than worry about global overpopulation, they warn darkly of the dangers of a world with too few babies, not enough working people, and an aging population. Like Malthus, they fear a demographic crisis could lead to a dismal future.

Yet they greatly underestimate the ability of technological and economic trends to overcome demographic shifts. It’s the same mistake Malthus made: He didn’t see that the advances of the Industrial Revolution, applied correctly, could lift incomes faster than population growth. Similarly, productivity growth over the next 50 years could blunt the impact of aging societies.

In fact, average living standards, as measured by gross domestic product per capita, could double by 2050 in most industrialized countries. That’s true even in demographically challenged nations such as Japan and Germany. Policymakers still must revamp the financing of government pension systems,

but even that task could be less arduous than many expect.

Consider Japan, where the working-age population is expected to shrink by 36% from 2000 to 2050. That does sound like a recipe for disaster, especially since the number of people 65 and over is predicted to rise at the same time.

The good news is that productivity gains over that stretch could easily compensate for the workforce drop. Since 1980, productivity growth in Japan has averaged 2% annually. If that pattern continues, output per worker will rise by a compounded 169% by 2050, and Japan’s GDP will grow by 72%.

True, the Japanese economy in 2050 will be supporting a larger number of elderly people and their expensive health-care needs. But the number of children and middle-aged families will drop as well. Take it all together, and the historical norm of 2% annual productivity growth could boost average income per capita in Japan by 71% by 2050—not a bad outcome.

Japan is not unique. If the U.S. and Britain can keep up their historical productivity-growth rates, their living standards could double by 2050. France, like Japan, has to boost its long-term productivity growth by only a few tenths of a percentage point to make up for its aging population. Among the large industrialized countries, the one in the biggest trouble is Germany. Even there, the rate of productivity growth needed to double living standards by 2050 is only half a percentage point higher than its historical average.

Still, productivity is not a total panacea, and for a simple reason: Most pension systems, including U.S. Social Security, tie old-age benefits to wages. This means that strong productivity growth will push up wages and boost tax revenues going into the pension system—but benefits to retirees will rise as well. If the elderly are numerous enough, higher productivity may even worsen the financial position of the pension system.

The best way out of the trap is to rejigger the rules that old-age benefits rely on—some—but not all—of productivity and wage gains.

Demographic factors alone won’t guarantee that future productivity growth falls short. That means that we should focus on the factors that encourage innovation, such as education and research and development, rather than fixate on the aging population. Our destiny, and that of our children, will be determined by technology, not demographics. ■

What’s Needed: Not That Big a Leap

In the coming decades, most industrial countries will see fewer workers supporting more dependents. Even so, a moderate increase in productivity growth would be enough to compensate for demographic shifts and double income per person by 2050.

	FRANCE	GERMANY	JAPAN	BRITAIN	U.S.
Annual growth rate of productivity needed to double income per person by 2050 (percent)*	1.8%	2.0%	2.3%	1.7%	1.6%
Historical growth rate of output per worker from 1980-2003 (percent)	1.5%	1.5%	2.0%	1.9%	1.7%

*Compared to 2000, with living standards measured by gross domestic product per person. Assumes that people 65 and over require twice the average spending to cover medical costs and other needs. Data: United Nations, Bureau of Labor Statistics, BusinessWeek.

EDITED BY ROSE BRADY

Iraq: After the Election, It Won't Get Easier

IN SPITE OF CONTINUED VIOLENCE, Iraq's planned Jan. 30 election looks to occur. It's unlikely to be either the decisive turning point the Bush Administration once hoped for or the unmitigated disaster critics predict. Instead, this vote at best will be a step on the difficult road toward creating a viable, self-governing country.

Electors will elect a 275-seat National Assembly, which will then face the daunting task of choosing a new government and drafting a constitution. The country's transitional law sets an ambitious deadline of June 15 for a draft constitution. The negotiations, in which Iraqis will have to grapple with dividing up power and oil wealth, largely determine whether Iraq gradually pulls itself out of the mire or remains a mess for years. "The assembly is going to face existential issues," says Phebe Marr, an expert at Washington's U.S. Institute for Peace. "The big question is whether Iraq is going to produce practical, responsible leaders who are willing to compromise."

Dozens of parties are vying for seats to be awarded under a system of proportional representation. Most analysts think the biggest contender will be the largely Sunni list put together at the behest of Ayatollah Ali al-Sistani, Iraq's most powerful religious leader. A slate sponsored by the two chief Kurdish parties is likely to be the other winner. Based on a recent poll, U.S. military analysts think the Shiites could win 40% to 45% of the vote, while the Kurds could poll 30%.

Many of the party lists are arranged on religious and ethnic lines—a worrying sign. But one politician steering away from a sectarian approach is Ayad Allawi, current Prime Minister. He has put together a nonreligious list in hopes of attracting Sunnis, nationalists, and others who don't want to be ruled by Shia religious leaders. If Allawi gets 60 to 70 seats, it will be very difficult not to have him continue as Prime Minister, says Ali Allawi,

a relative and former Defense Minister. Other candidates for Prime Minister include Ibrahim Jaafari, leader of the Da'wa Party, a Shia group affiliated with al-Sistani, and Hussein Shahrastani, a nuclear scientist and the Ayatollah's most trusted political adviser. The Prime Minister will be chosen by a three-person council whom the National Assembly will select. Analysts think this indirect process leaves an opening for the U.S. to exert its influence.

Islamic republic?

After the government is chosen, Iraq's power brokers will have to find answers to tough questions. Among them is how much religious law will govern the new state. Although al-Sistani's intentions aren't clear, most analysts think he opposes the creation of an Iran-style Islamic republic. Another issue will be satisfying Kurdish demands for autonomy. The Kurds are running a quasi-state of their own in the north and have designs on oil fields around Kirkuk. The future role of the U.S. is also a problem. The Kurds want a permanent U.S. presence, while even moderate Sunnis insist that U.S. troops leave soon.

The stakes couldn't be higher. If the winners don't compromise, Iraq could split into ethnic and sectarian zones. The Kurds could break away. And many Sunni Muslims, the big losers from Saddam Hussein's fall, sympathize with or are participants in the raging insurgency. Unless statesmen emerge, the vote may be remembered as Iraq's first step on the road to oblivion. ■

—By Stanley Reed in London,
with Stan Crock in Washington



ALLAWI He has put together a secular slate

GLOBAL WRAPUP

MORE WOES FOR BRITAIN'S TORIES

THE BAD news just keeps coming for Britain's Conservative Party leader **Michael Howard**. A recent poll by agency Populus Ltd. predicted another victory for the Labour Party in parliamentary elections expected on May 5. Only 33% of Britons will vote for the Conservatives, vs. 38% for Labour, Populus says. Howard didn't improve Tory chances with his Jan. 17 pledge to slash taxes by just \$7.5 billion if the Conservatives win. Critics called the tax cut, which amounts to less than 1% of estimated 2005 tax receipts, much too small. Backbenchers aren't pleased with Howard's leadership. On Jan. 16, Conservative MP **Robert Jackson** defected to Labour, calling the Tory agenda "incoherent."

VENEZUELA'S OIL GIANT STILL IN DISARRAY

TROUBLES AT **Petróleos de Venezuela (PDVSA)** led Standard & Poor's to downgrade Venezuela's credit rating on its \$23.6 billion in foreign debt on Jan. 18. The downgrade to "selective default" came after Venezuela missed an estimated \$35 million payment on oil-indexed obligations. PDVSA hasn't fully recovered from its general strike in 2002-03, which resulted in the firing of 17,000 employees. The company is behind on filing financial statements. As a result, the government said it was unable to calculate and make the payment due. Venezuela's normal B credit rating is lower than some other oil producers because the country depends on oil for more than 80% of export revenue. The government has nearly depleted a \$6 billion oil stabilization fund by tapping it for social spending.



Back to Earth For Apollo Group?

High marketing costs could slow growth
for the University of Phoenix parent

LAST FALL, WHEN APOLLO Group paid a big fine to the U. S. Education Dept. to close an investigation of aggressive recruiting practices by its University of Phoenix subsidiary, many investors feared the fast-growth company was about to hit the wall. By November, the stock had plunged 36%, to \$62.55—an abrupt reversal of the previous 4½ years, when Apollo's price rose from \$9 to \$98.

Since then, Apollo Group Inc. CEO Todd

S. Nelson has worked feverishly to reassure investors that the scandal was nothing more than a hiccup. In mid-December, the Phoenix-based company reported that net income and sales surged 30% in the quarter ended Nov. 30, the first since the scandal broke. Nelson insists he sees plenty of room for expansion, including plans to charge overseas and to enter the market to serve younger college students. "The next five to 10 years look very,

OPTIMISTIC CEO Nelson is targeting a younger audience

very profitable, he says.

But Apollo has to fill

classroom seats to keep up its pace—it is paying an ever-increasing cost, so. The company already has 28 students. Some 90% of those are at the University of Phoenix, making it far the nation's largest private university. Apollo also runs separate schools of financial planning and professional development and Western International small university. Given that size, it adds nearly 57,000 students—the equivalent of another University of Texas at Austin—in the past 12 months to make its growth target.

And Apollo spent \$383 million on marketing last year—a staggering amount, considering that few universities spend even \$10 million. Marketing surged 48% in the first quarter, to 2 of revenues, up from just 15.8% in True, Apollo's earnings last year grew an impressive 36%, to \$336 million, plus special charges, on 34% higher revenue of \$1.8 billion—vaulting it to the top spot on the BusinessWeek 50 ranking of top-performing companies. But P. Nassirian, associate executive director of the American Association of College Registrars & Admissions Officers, says, "This rate of growth may not be sustainable." His group represents trade colleges, many of which are critical to Apollo. But even Nelson expects revenue to grow at a slower 27% pace this year.

BOILER ROOM

UNTIL RECENTLY, Apollo had the vision of its back. John G. Sperling, who founded Apollo in 1976, was a visionary who saw a huge untapped market in working adults who needed degrees to get ahead but couldn't fit into the rigid schedules of many colleges. Phoenix caters to them by offering courses at convenient times and locations. In the early 1990s, Phoenix made it even easier when it became

the first universities to offer full degree programs online. With many employers willing to foot all or part of the \$10,000 yearly tuition tab, enrollment has grown nearly 100% over the past decade.

But Apollo's reputation was sullied in September when a release of the Education Dept. report by authors depicted a high-pressure sales culture that resembled a telemarketing room more than a university administrative office. "Phoenix recruiters soon fr



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Vehicles shown with available equipment. ©2004 Toyota Motor Sales, U.S.A., Inc.

that UOP bases their salaries solely on the number of students they recruit," the report charged. That's prohibited by federal law. One recruiter who started at \$28,000, for instance, was bumped to \$85,000 after recruiting 151 students in six months. But another who started at the same level got just a \$4,000 raise after signing up 79 students.

Ultimately, such violations could have led the government to bar Phoenix from the federal student loan program, crippling the university. Nelson calls the report "very misleading and full of inaccuracies." But he says he decided to settle rather than wage a protracted fight. Apollo agreed to change its compensation system and pay a \$9.8 million fine without admitting guilt. Still, Apollo's defenders note that the point of the law is to prevent for-profits from luring unqualified students. If Phoenix is doing that, it hasn't showed up in student-loan default rates, which remain a low 6%.

FOREIGN EXPANSION

WITH THE REGULATORS off its back, Apollo is once again focusing on growth. The online program, with 133,000 students, is far from saturated. And for the first time Apollo is targeting high school graduates, who are expected to hit a record later this decade. Similarly, Apollo has barely begun to scratch the international market, where experts see huge demand for U.S.-style education. Phoenix plans to open its first Mexican campus this year, and Nelson also has big hopes for China, where Apollo's Western International University now has just 50 students.

But future growth won't come as easily as it has in the past. Phoenix was once one of the only players online. Now it faces a lot more competition from public universities and other for-profits, warns Sean R. Gallagher, senior analyst at Eduventures Inc., a Boston-based researcher. Most worrisome, though, are the rising marketing costs. "The big question now is whether that means the economics of this business are changing," says Gregory W. Cappelli, an analyst at Credit Suisse First Boston.

Until that's answered, even Cappelli, who calls Apollo "a fantastic company," is urging a "neutral" attitude toward its stock, now at \$82. This onetime star is teaching a new course in caution. ■

—By William C. Symonds in Boston

IN DEMAND The market is growing in the U.S. and abroad



Chiron's Flu Aches May Last Awhile

Its vaccine rivals are gaining traction—and its other businesses are just so-so

AT THE RECENT J.P. Morgan Health Care Conference in San Francisco, Howard Pien, CEO of embattled flu-vaccine maker Chiron Corp., faced a less-than-friendly Wall Street crowd. During a presentation on Jan. 12, Pien euphemistically called 2004 "a momentous" year for the Emeryville (Calif.) biotech, which had to withdraw from this season's flu market after British regulators shut down its manufacturing plant in Liverpool. Audience members crossed their arms and rolled their eyes as Pien promised to try to get Chiron back in the game for next season. "They have a lot of digging out to do," said Morgan analyst Ronald C. Renaud Jr. after Pien's speech.

Pien may not have a big enough shov-

el. He has admitted that it's unlikely vaccine problem will be resolved quarter, and Chiron can't yet promise to supply its vaccine, Fluvirin, next season. That could leave the door wide open for rivals and new U.S. flu players, including pharma giant GlaxoSmithKline, which is racing to get its vaccine proved in the U.S. Even after Chiron opens its plant, it may never regain 50% share of the market it once enjoyed. Meanwhile, Chiron's other two businesses—making biotech drugs and blood-testing tools—aren't doing well enough to fill the vaccine void.

The flu debacle has hit Chiron hard. On Jan. 26 the company is expected to report that 2004 earnings fell by 1% from the previous year, to \$78.5 million on flat sales of \$1.8 billion. In December British authorities slapped a second suspension on Chiron's plant, which co-

BusinessWeek online For a Q&A with CEO Todd Nelson, go to www.businessweek.com/extras



it shut down until April. A few days after the U.S. Food & Drug Administration sent Chiron a warning letter citing concerns about its manufacturing practices. The Justice Dept. is investigating, and the Securities & Exchange Commission has launched an informal probe, and multiple shareholder lawsuits have been filed. "Chiron has taken a systemic approach to addressing the observations made by the regulatory authorities," says a Chiron spokesperson, who adds the company is working "everything feasible" to be able to restart vaccine production next season.

ING CUSTOMERS

A WONDER Wall Street still has some faith in Chiron's recovery. Chiron's stock, after falling more than 30%, to \$20 on news of the plant suspension, has climbed back to \$34. That optimism has been fueled by analysts such as Jennifer Chao of Deutsche Bank Securities, who upgraded the stock to a "buy" in early January. The bank owned 1% of Chiron's shares as of January 30. Despite new players in the market, Chao believes Chiron can easily reclaim its share of vaccine sales if it resolves the manufacturing issues soon. "Competitors will only scale up as a reaction of Chiron's [inability] to ramp up Liverpool," she says. Chiron's rivals say that theory isn't standing up. In December, Chiron began a trial in the U.S. of a new vaccine, which it hopes will be

approved by the FDA in time for next year's season. Canadian biotech ID Biomedical Corp. has also sped up its efforts to get its vaccine approved in the U.S., and in December it signed long-term contracts to supply the product to three of the biggest flu-vaccine distributors. "We need to diversify our sources," says Doug Shaver, vice-president of marketing for McKesson Corp.'s Medical-Surgical unit, one of the companies that signed on with ID Biomedical. McKesson is also a Chiron customer.

Sanofi-Aventis, the other major vaccine provider, is already operating at peak capacity. This year it was able to produce 8 million extra doses by extending its manufacturing schedule. The company could make the same amount next year. If Chiron's plant is still out of commission when Sanofi starts taking orders—possibly before the end of the quarter—the distributors and health-care providers who order the vaccine will probably turn to suppliers that they know they can rely on.

Sanofi and other Chiron competitors consider flu vaccine to be a long-term growth opportunity. Health-care agencies such as the Centers for Disease Control & Prevention want to double the immunization rate in the U.S., and demand in some overseas markets, including Southeast Asia, is growing at double-digit rates. Sanofi is planning to increase its manufacturing capacity in coming years to meet the demand. "That has been our long-term plan, outside of the Chiron situation," says Wayne Pisano, executive vice-president for commercial operations at Sanofi's vaccine unit.

Chiron's vaccine troubles wouldn't be such a worry if its biotech drugs made up the slack. Sales of Chiron's three major products—for patients with cystic fibrosis, multiple sclerosis, and some forms of can-

Regulators could keep the Liverpool plant shut until April

cer—grew an estimated 12% in 2004. But competition looms, especially for Beta-son, the multiple sclerosis treatment. In November, Biogen Idec Inc. won approval for Tysabri, a drug that could take a chunk of Chiron's customers. Chiron has one niche product awaiting FDA review, but its experimental drugs with blockbuster potential are nowhere near hitting the mar-

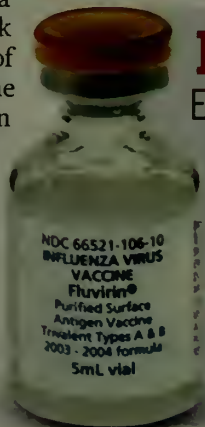
ket. Analysts have long hoped the 23-year-old company would crank out a string of highly profitable biotech drugs. "They have a tradition of putting a lot of investment there and not getting a lot out," says Jay Markowitz, an analyst at T. Rowe Price Group Inc., which owns Chiron shares.

STILL HOPEFUL

THE ONE BRIGHT SPOT is Chiron's unit that makes tools to screen the blood supply. In 2004, sales grew an estimated 22%, to \$278 million, largely on the strength of Procleix, a test for HIV and Hepatitis B and C that has been adopted worldwide. But some of last year's growth came from one-time royalties and license fees, and many analysts expect sales growth to drop by half this year. Furthermore, gross profit margins in blood testing are around 40%, far lower than the 70% margins in biotech and potential margins in vaccines.

For his part, Pien hasn't given up hope. At the J.P. Morgan conference, Chiron's CEO laid out the list of inspections that U.S. and European regulators will conduct at the Liverpool plant before they will allow it to release flu vaccine. But with competitors eager to lock up orders for the next flu season, Chiron may be stuck on its sickbed for quite a while longer. ■

—By Arlene Weintraub in New York, with Sarah Lacy in San Francisco and Kerry Capell in London



Risky Business

Even if Chiron can get its flu-vaccine plant back on line, it faces major hurdles in all of its units. Each accounts for about a third of Chiron's \$1.8 billion in annual sales:

VACCINES Chiron will struggle to regain its 50% market share in flu vaccines, as new rivals race to grab share

BLOOD TESTING Sales of screening tools grew more than 20% last year, although strength here isn't enough to make up for profit shortfalls elsewhere

BIOTECH Products include a drug to treat multiple sclerosis, but falling royalties and higher costs cut profits by 39% through September

Taking Quick Aim Against Snipers

The Pentagon needed a way to counter attacks in Iraq. It got results in short order

JUST OVER A YEAR AGO, the head of the Pentagon's esteemed research agency called an urgent staff meeting. Snipers in Iraq were killing U.S. soldiers. Often, troops in noisy Humvees didn't even know they were being shot at until someone was hit, said Tony Tether, director of the Defense Advanced Research Projects Agency. So could DARPA's famous brainiacs concoct an inexpensive system to spot incoming bullets instantly and pinpoint where they came from? If the system saved just one life, it would be worth it, Tether told the group.

Wartime demands are a powerful spur to progress

So began a crash project that not only has saved lives but also offers larger lessons about technology development. Research teams in France, Canada, and elsewhere have developed bullet-tracking systems. But the Pentagon wanted one capable of functioning on the move and cheap enough and small enough to place on many vehicles, enabling troops to return fire quickly.

It wasn't an easy task. "It's hard to innovate on command—it takes a certain breed of craziness," explains Robert G. "Tad" Elmer, president of BBN Technologies in Cambridge, Mass., which succeeded in building the system. In this case, it required a tough deadline, a team approach, extensive feedback from the troops, and new ideas. As an improved version of the system now undergoes its final tests, it also illustrates how the

demands of war are a powerful spur to progress.

A longtime DARPA research and development contractor and builder of the precursor of the Internet, BBN had won a DARPA contest for a cruder stationary bullet-detecting system in 1997. So when Tether issued his challenge, DARPA called BBN. Could the company create a system that worked on the move? In 60 days? And deliver 50 working units? The answers, recalls BBN Chief Technologist Steve Milligan, were "yes, yes, and can we call you back Monday morning?"

By Monday, Milligan thought it was

possible, and on Nov. 17, 2003 signed the contract with DARPA. The company's researchers knew the physics was straightforward. Like sonic airplanes, bullets create waves—mini-sonic booms—as they speed through the air. So if you arrange seven microphones like the spines of a sea urchin, a shock wave from a bullet will hit each microphone at a slightly different time, like a wave lapping against different pebbles on a beach. By measuring those time differences, it's possible to calculate the trajectory.

As it turned out, "it was much harder than we thought it would be," says Milligan. Not only is the math difficult, but the system also had to work in the cacophony of urban warfare, including echoes from shots—and do it on the move.

The first step was hastily assembling the seven-microphone array and outfitting it with electronic equipment over the Thanksgiving weekend and driving it down to Quantico Marine base in Virginia for a week of collecting data on actual shooting. The conditions were horrible—"snowy, freezing, and rainy," recalls DARPA Program Manager H. Wood. Once it had hundreds of hours' worth of data, BBN's team tackled the software. It was Milligan who came up with the breakthrough, recalls Wood, by playing programs known as genetic

Incoming Bullet

Inside their Humvees, American troops may not know they're being shot at—until a bullet hits. Here's how DARPA's crash project is helping soldiers get a bead on incoming fire:

THE SHOCK WAVE from a supersonic bullet hits each of seven microphones at slightly different times. In a fraction of a second, software algorithms on a computer in the Humvee analyze the microphone data to calculate where the bullet is coming from.

A DISPLAY in the Humvee tells soldiers where the sniper is. When networked, systems on more than one vehicle will extend their range.

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Short-Term Bond Fund (PRWBX)	1.49	5.46	5.56	2.87%
Lipper Short Investment-Grade Debt Funds Average	1.35	4.57	5.34	
<u>Tax-Free Bond Funds</u>				
Tax-Free High Yield Fund (PRFHX) ⁴	6.64	6.58	6.39	4.34%
Lipper High Yield Municipal Debt Funds Average	6.10	5.87	5.78	
Tax-Free Income Fund (PRTAX) ⁴	4.31	7.02	6.63	3.39%
Lipper General Municipal Debt Funds Average	3.70	6.27	6.06	

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rhythms. These start out with equations that offer potential solutions, then mutate them repeatedly, like evolution on fast-forward. Ultimately, a solution emerges that fits the observed data almost perfectly. "We can run what amounts to thousands of generations in a fraction of a second," says Milligan.

Then his team romped around Cambridge in a pair of Humvees to tune the system so that it wasn't fooled by normal urban bangs and jolts. They cajoled suppliers into making special production runs of key components. And everyone pitched in to screw and solder 50 units together.

BBN missed the deadline by just six days. By early March, 40 of the systems,

dubbed Boomerang, were installed on vehicles in Iraq. They did save lives, but there were glitches. The biggest problem was that radio signals confused the units. Marines also thought the array was too big a target.

Next up: A sniper detector that can fire back

So the company went back to the drawing board to create an improved Boomerang. Engineers shrank the array to one-third of its former size, shielded the unit from radio interference, improved the display, and added networking capabilities and the ability to tell soldiers the elevation and range of a sniper, in addition to just the direction. In December, the new version sailed through radio interference testing. In the first week in January, it passed a durability test. The week after, it aced the performance tests. "I had no idea we were going to end up being as successful as we were," Wood says.

The next step will be building a set of Boomerangs to help the troops. And as the needs of war push the development of technology, the longer-term plans are more ambitious. Linking Boomerangs together in a wireless network will substantially extend their range. Similar systems might help defend helicopters. And there are plans to combine sniper systems with the ability to fire back, as in a Navy/Marine project called Gunslinger. One vision is a completely robotic vehicle capable of patrolling city streets, spotting and responding to any snipers in its path. It all demonstrates how rapid innovation amid the urgency of war can protect soldiers in the combat zone. ■

—By John Carey in Arlington, Va.



CAPELLAS Ready to put a \$6 billion piggy bank to work

'We're Not a Phone Company'

CEO Capellas is pushing MCI into tech services. Can he keep buyers at bay?

THESE HAVE BEEN DOG days at MCI Inc. Beaten down by an \$11 billion accounting scandal, bankruptcy, and a brutal price war, the long-distance giant is expected to lose \$3.8 billion in 2004. Its disgraced former chief executive, Bernard J. Ebbers, just went on trial for accounting misdeeds. And after 18,000 job cuts in three years, the cavernous halls of its Ashburn (Va.) headquarters echo.

Visit the corner office of CEO Michael D. Capellas, though, and little seems

amiss. He bounds about shooting from his mobile phone and delivering talks about the wave of companies adopting Internet technology for ever communications. Asked how an old telecom company can hope to surf the wave, he says: "It's called \$6 billion cash and zero net debt."

Now *BusinessWeek* has learned that beleaguered long-distance company poised to put its piggy bank to work goal: to overhaul MCI from a shrinking carrier of commoditized voice traffic to a New Age network that delivers high-margin Web services such as comp

ty. To do it, MCI plans to convert
ands of miles of cable in its tradi-
phone network over the next two
to Internet technology capable of
ng the billions of bytes necessary to
r such services.

re important, MCI is planning on
g a series of at least three acquisi-
in the first half of this year to beef up
h services it can offer corporate cus-
s, according to two insiders. It's a
over that Capellas believes will allow
to survive as an independent compa-
We've got the time, we've got the net-
and we've got the customers," he
"We're not a phone company any-
We're going to define ourselves on
own terms."

A-WALL

LLAS IS KICKING off the transfor-
n by plunging into the security busi-
On Jan. 20, MCI expects to complete
quisition of Network Security Tech-
ies Inc., whose customers include
ers Group, Time Warner, and the U.S.
ury. The company's software is ded-
d to allow MCI to stop viruses and
s before they ever reach its cus-
rs' desktops. The idea is that large
orate and government customers will
MCI monthly fees of \$100,000 or
to protect them, rather than spend-
illions to erect their own defenses.
ext up are acquisitions that will let
expand its software hosting, which al-
companies to use a program for pro-
g e-mail or other functions without
assle of installing and managing it
selves, and content delivery, so com-
es can stream audio and video into of-
and conference rooms. "MCI recog-

nizes a fundamental truth: It is impossible
to survive on basic [telephone] revenue.
They have to climb the food chain," says
Thomas L. Nolle, president of CIMI Corp.,
a New Jersey telecom consulting firm.

Or get gobbled by a rival. MCI is one of
the most frequently mentioned takeover
targets in the industry and Capellas, de-
spite his ambitious strategy, will have
trouble keeping the company out of the
jaws of its rivals. MCI's market cap is a
meager \$6.2 billion, barely more than its
cash, and less than half the value of AT&T.

And Capellas' new Net services won't
generate enough sales to compensate for
plunging telecom revenues anytime soon.
The company's sales are ex-
pected to drop 17.4% this
year, to \$16.9 billion, ac-
cording to UBS Securities, af-
ter a 16% decline in 2004. "It
is not going to be easy finan-
cial sledding for Capellas,"
says one telecom consultant
who has done work for MCI.
Among the most likely ac-
quirers are the Bells, possibly
SBC Communications or
BellSouth, and a foreign
telecom player, such as
British Telecom.

One reason Capellas may come up short
is that his competition promises to be gru-
eling. Tech service giants IBM and Accen-
ture Ltd. have been pitching corporate tech
departments to let them manage their ap-
plications for years. Networking-equip-
ment makers such as Juniper Networks
Inc. and Cisco are embedding security into
their own gear to protect corporate com-
puters. And archrival AT&T is pursuing a
strategy that's similar to MCI's—and it's

**AT&T has
a similar
strategy—
and by some
measures is
ahead**

ahead on several fronts. AT&T already is
offering its own computer security and
software hosting services. "MCI doesn't
have much chance competing head to
head," says analyst Melanie Posey of mar-
ket researcher IDC.

Capellas is unfazed. He's racing for-
ward with plans to upgrade the company's
100,000-mile network, a project expected
to cost \$500 million over the next two
years. Some customers already are buying
his pitch. Northbrook (Ill.)-based insur-
ance giant Allstate Corp. is wiring new of-
fices with Web phones and plans to tear
out all of its old analog lines by 2007. It se-
lected MCI to handle its telephone busi-

ness because of its reliability
and customer service and
expects to save 3% annually
on its phone bills. The com-
pany plans to hand over
computer security to MCI in
the near future. "If only one
person handles it, the cost
goes down," says Allstate
Chief Technology Officer
Catherine S. Brune.

Capellas recognizes the
tradeoff of his repositioning.

MCI is going to become a
smaller company, but he firmly believes he
will be able to return it to profitability with-
in the next few years. "That's the price of
poker," he says. He expects software host-
ing and security to deliver profit margins
that are twice those of basic voice and data
transmission. Analyst John Hodulik of UBS
Securities says MCI could even make a
very small profit in 2005.

For now, Capellas' lofty goals have lift-
ed the cloud that has hung over MCI since
predecessor WorldCom went belly-up in
2002. In November, Capellas wound up a
26-city, 30-day tour to pitch employees
on the makeover. On stressful late nights
shaping that plan, Capellas and crew took
to singing karaoke. Their favorite lyrics:
"I get knocked down, but I get up again,"
from British band Chumbawamba's
Tubthumping.

Capellas and his team will need all the
perseverance they can muster. As they try
to deliver on MCI's new strategy, the tra-
ditional phone business is evaporating
and potential acquirers are circling. Sure
to take more lumps, MCI is fighting hard
to get back on its feet. ■

—By Brian Grow and Catherine Yang in
Ashburn, Va., with Roger O. Crockett
in Chicago

The Nuts and Bolts of MCI's Turnaround Plan

attered by scandal, bankruptcy, and a price war in recent years,
MCI's traditional business is down more than 35% since 2002, to
\$1.5 billion. Here's how Michael Capellas plans to fix the company:

STRATEGY MCI intends to move from the cutthroat long-distance business into
higher-margin services. The services? Computer security to protect corporate
works from viruses, content delivery to stream audio and video into offices, and
software hosting to let companies use the software for processing e-mail or other
actions without the hassle of installing and managing it themselves.

DEALS MCI says it will buy at least three companies in security, content delivery,
and hosting in the first half of the year, kicked off by the \$105 million purchase of
Network Security on Jan. 20. It also plans to launch a wireless service for businesses
and hire 250 tech-savvy salespeople from companies such as Cisco and Microsoft.

COST Capellas plans to spend \$500 million to upgrade MCI's network to deliver
new services and then use some of MCI's \$6 billion cash pile for acquisitions.

Data: MCI Inc. and BusinessWeek

BusinessWeek online For more on MCI's
strategy, including a Q&A with CEO Capellas,
go to businessweek.com/extras



LINUX INC.

Linus Torvalds once led a ragtag band of software geeks. Not anymore. Here's an inside look at how the unusual Linux business model increasingly threatens Microsoft. **BY STEVE HAMM**

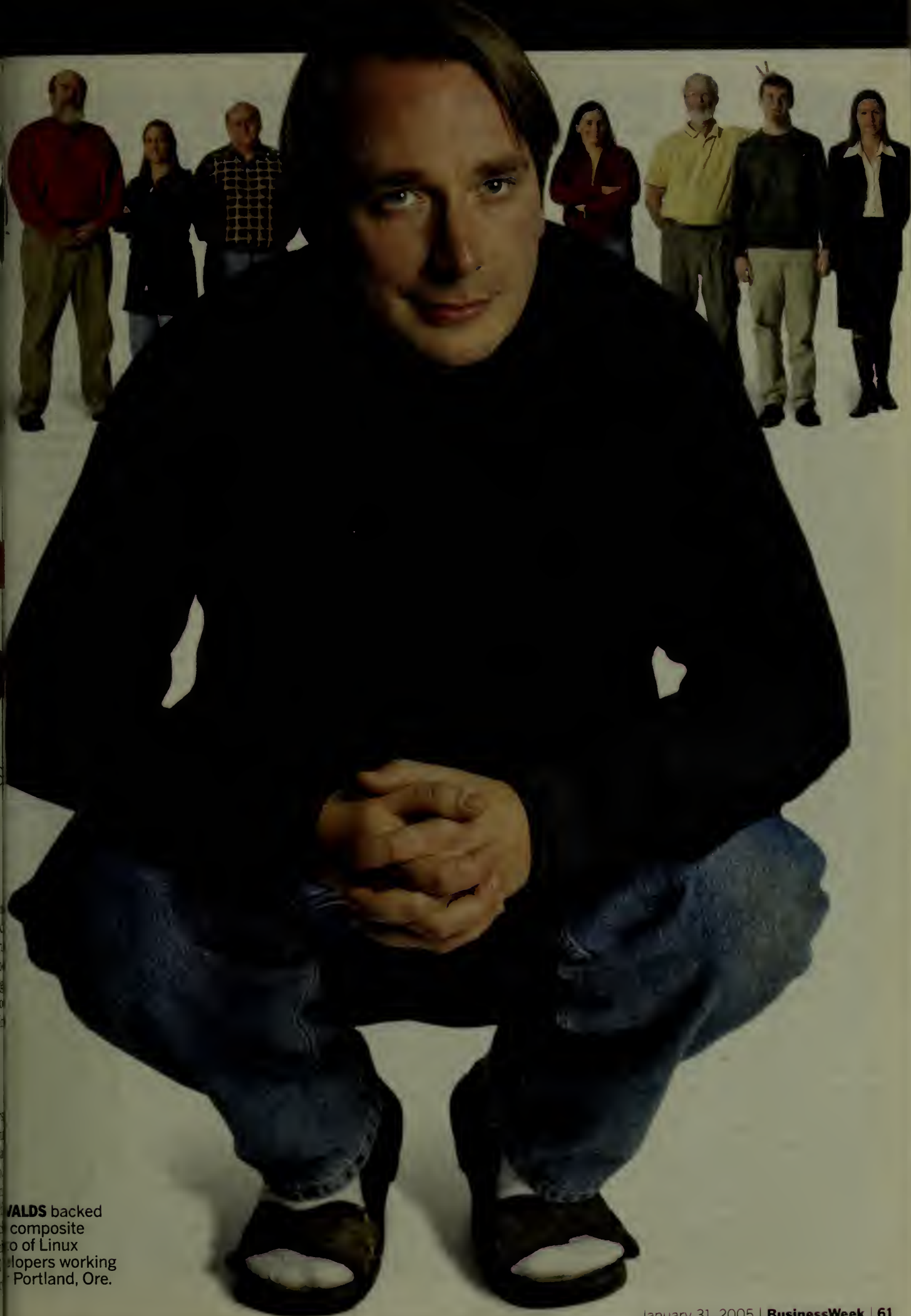
FIVE YEARS AGO, LINUS TORVALDS FACED A MUTINY. THE reclusive Finn had taken the lead in creating the Linux computer operating system, with help from thousands of volunteer programmers, and the open-source software had become wildly popular for running Web sites during the dot-com boom. But just as Linux was taking off, some programmers rebelled. Torvalds' insistence on manually reviewing everything that went into the software was creating a logjam, they warned. Unless he changed his ways, they might concoct a rival software package—a threat that could have crippled Linux. “Everybody knew things were falling apart,” recalls Larry McVoy, a programmer who played peacemaker. “Something had to be done.”

The crisis came to a head during a tense meeting at McVoy's house, on San Francisco's Twin Peaks. A handful of Linux' top contributors took turns urging Torvalds to change. After an awkward dinner of quiche and croissants, they sat on the living room floor and hashed things out. Four hours later, Torvalds relented. He agreed to delegate more and use a software program for automating the handling of code. When the program was ready in 2002, Torvalds was able to process contributions five times as fast as he had in the past.

The Twin Peaks truce is just one of the dramatic changes during the past few years in the way Linux is made and distributed. The phenomenon that Torvalds kicked off as a student at the University of Helsinki in 1991 had long been a loosely organized, goosey effort, with little structure or organization. Young programmers and caffeine-jazzed iconoclasts wrote much of the code in their spare time, while the overtaxed Torvalds stitched improvements almost singlehandedly.

TURNING PRO

TODAY, THAT APPROACH is quaint history. Little under the radar by the outside world, the community of Linux programmers has evolved in recent years into something much more professional, organized, and efficient. Put bluntly, Linux has turned Torvalds now has a team of lieutenants, nearly all of them employed by tech companies, that oversees development of priority projects. Tech giants such as IBM, Hewlett-Packard, and Intel are clustered around the Finn, contributing technology, marketing muscle, and thousands of professional programmers. IBM alone has 600 programmers dedicated to



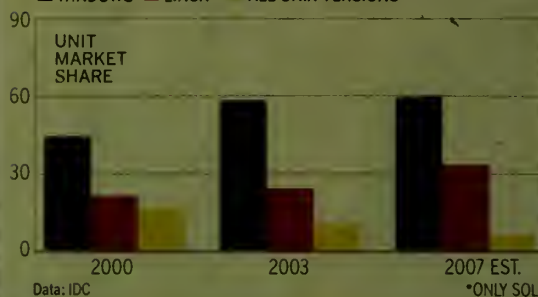
VALDS backed composite
o of Linux
lopers working
Portland, Ore.

WHERE LINUX IS GOING

Over the past 13 years, the Linux operating system has added capabilities that corporations demand

SERVERS Linux gains in server operating systems could freeze Microsoft at its current market share

■ WINDOWS ■ LINUX* ■ ALL UNIX VERSIONS



DESKTOPS Although Microsoft remains dominant, Linux is expected to hit 6% in 2007, from 3% in 2003

■ WINDOWS ■ LINUX* ■ MAC OS



ux, up from two in 1999. There's even a board of directors that helps set the priorities for Linux development.

The result is a much more powerful Linux. The software is making its way into everything from Motorola cell phones and Mitsubishi robots to eBay servers and the NASA supercomputers that run space-shuttle simulations. Its growing might is shaking up the technology industry, challenging Microsoft Corp.'s dominance and offering up a new model for creating software. Indeed, Torvalds' onetime hobby has become Linux Inc. "People thought this wouldn't work. There are just too many people and companies to hang together. But now it's clear it does work," says Mark Blowers, an analyst at market researcher Butler Group.

Not that this Inc. operates like a traditional corporation. Hardly. There's no headquarters, no CEO, and no annual report. And it's not a single company. Rather, it's a cooperative venture in which employees at about two dozen companies, along with thousands of individuals, work together to improve Linux software. The tech companies contribute sweat equity to the project, largely by paying programmers' salaries, and then make money by selling products and services around the Linux operating system. They don't charge for Linux itself, since under the cooperative's rules the software is available to all comers for free.

How do companies benefit from free software? In several different ways. Distributors, including Red Hat Inc. and Novell Inc., package Linux with helpful user manuals, regular updates, and customer service, and then charge customers annual subscription fees for all the extras. Those fees range from \$35 a year for a basic desktop version of Linux to \$1,500 for a high-end server version. The dollars can add up. Red Hat, which employs 200 programmers, is expected to see profits triple, to \$53 million, in its current fiscal year, as revenues surge 56%, to \$195 million.

Those numbers are dwarfed by the winnings for computer makers that sell PCs and servers preloaded with Linux. IBM, HP, and others capitalize on the ability to sell machines without any up-front charge for an operating-system license, which can range up to several thousand dollars for some versions of Windows and Unix. At HP, sales of servers that run the Linux operating system hit nearly \$3 billion during the past fiscal year, almost double the tally three years ago.

In the Linux community, this kind of red-meat capitalism is combined with the sharing philosophy of the open-source movement. Dick Porter, a T-shirted coder who often works under an apple tree in his garden in Wales, is on the same team with Jim Stallings, a hard-charging ex-Marine who travels the

world making deals for IBM. What they have in common is a keen interest in making Linux ever more capable. The result is a culture that's cooperative, meritocratic—and Darwinian at the same time. Any company or person is free to participate in Linux Inc., and those with the most to offer win recognition and prominent roles. "Linux is the first natural business system," says James F. Moore, a senior fellow at the Berkman Center for Internet & Society at Harvard Law School.

STRANGE GROUND

TO UNDERSTAND THE inner workings of Linux Inc., *Business Week* took a journey through the fast-evolving ecosystem. The unusual trip included everything from sitting in on grumpy developer meetings to interviewing dozens of tech execs and engineers from Germany to China. One stop was Torvalds' home, just south of Portland, Ore. The 34-year-old moved from Silicon Valley last summer, in part because he was hired by the Be

HOW LINUX INC. WORKS

Developing new versions of the Linux operating system requires coordination among individuals and dozens of technology companies. Here's a look at the development process



1 SETTING PRIORITY GOALS

Torvalds begins setting goals with help from contributors. Three years ago, they decided on priorities for the version just now hitting the market. Two goals: Making it easy for people to use Linux on laptops and beefing up the system so it would handle the largest databases.

2 PUTTING EMPLOYEES TO WORK

Engineers at companies begin writing code for the new capabilities. In the latest version, they worked on Linux run on be computers with more processing power. Their creation, "maintainers" are responsible for reviewing.

Ore.) Linux advocacy group Open Development Labs Inc. (OSDL). He spent several hours talking about Linux as three towheaded daughters played by. Something of a rock star in techie circles, he was preparing for a flight to Los Angeles for the premiere of *Shark Tale*—which was animated on Linux computers—and was taking along his oldest daughter, Patricia, then 7 years old.

What's clear from these interviews is that the organization supporting Linux matured more dramatically than outsiders realize. While Torvalds remains at its center, he has ceded some control and accepted lots of help, thanks to some prodding from individual programmers like McVoy and some coaxing from tech giants whose fortunes have become inextricably tied to Linux.

One important step was the move by IBM, Intel and others to set up OSDL as the focal point for accelerating Linux adoption.

Perhaps most surprising, the legal attacks on Linux over the past year have unified the community. There continue to be internal tensions—for instance, Linux backers fret that different versions of the software will become incompatible with one another. Yet a suit by SCO Group Inc., a software company that claims IBM handed some of SCO's intellectual property to Linux, gave Linux aficionados the motivation to coordinate their efforts as never before. Tech companies have opened checkbooks to pay for administrative support, including a staff that scans every stitch of code to make sure it can withstand patent scrutiny. Even Linux' original idealists, who have

Bold Advances

Linux is making its way into Motorola cell phones, eBay servers, Mitsubishi robots, and NASA supercomputers

grumbled at times about the corporatization of the community, put their complaints on hold and rallied to defend their baby. The SCO suit against IBM is slated for trial late this year.

Put it all together, and Linux has become the strongest rival that Microsoft has ever faced. In servers, researcher IDC predicts Linux' market share based on unit sales will rise from 24% today to 33% in 2007, compared with 59% for Windows—essentially keeping Microsoft at its current market share for the next three years and squeezing its profit margins. That's because, for the first time, Linux is taking a

bite out of Windows, not just the other alternatives, and is forcing Microsoft to offer discounts to avoid losing sales. In a survey of business users by Forrester Research Inc., 52% said they are now replacing Windows servers with Linux. On the desktop side, IDC sees Linux' share more than doubling, from 3% today to 6% in 2007, while Windows loses a bit of ground. IDC expects the total market for Linux devices and software to jump from \$11 billion last year to \$35.7 billion by 2008.

In response, Microsoft has launched a counterattack against what it calls its No.1 threat. The software giant's "Get the Facts" publicity campaign claims that Windows is more secure and less expensive to own than Linux. Microsoft has notched some victories. The city government of Paris, for instance, decided in October against a complete switchover to Linux, citing the costs of such a change. Now that Linux distributors are charging more for subscriptions, Microsoft figures that it can use the same cost-benefit arguments that helped bury old rivals,



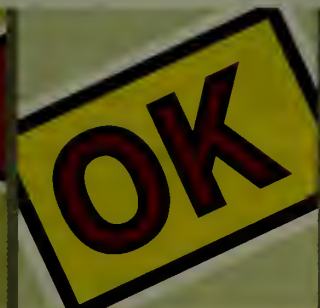
1 INDIVIDUAL PROGRAMMERS SET UP

Programmers, in their spare time, at home. For years, these programmers worked on their own. It would take Linux to run on a notebook including a feature for power management. They did their work to others.



4 WHIPPING THE CODE INTO SHAPE

The maintainers, most of whom work for technology companies even though they're Torvalds' lieutenants, ask for improvements in the "patches" offered to them by contributors. When they're satisfied, they pass chunks of software along to Torvalds and his top aide, Andrew Morton.



5 PASSING THE TORVALDS TEST

Torvalds and Morton review the code, ask for improvements, and ultimately, add it to the kernel—the central piece of the operating system. The pair regularly posts new updates so thousands of people worldwide can test it. Finally satisfied, Torvalds released Linux 2.6 on Dec. 18, 2003.



6 PUTTING TOGETHER THE PACKAGE

Linux distributors such as Novell and Red Hat assemble products, including the kernel and applications, such as the Firefox browser. Novell released its new server package back in August, 2004. Red Hat's proposed target date for release: Early 2005.



7 REACHING THE CUSTOMER

Corporations begin installing the newest versions. Last August, Hewlett-Packard released a laptop using Linux, becoming the first major supplier to do so. Technology companies such as HP, IBM, and Oracle start asking customers what they want in the next update of Linux.

STALLMAN In the '80s he launched the Free Software movement



such as Netscape Communications Corp. "It's getting to be much more like the old world instead of the new world for us, and we know how to compete with that kind of phenomenon," says Microsoft Chief Executive Steve Ballmer.

But Ballmer may have a tough time persuading customers that Windows is cheaper than Linux. It often isn't. With Windows, end users pay an up-front fee that ranges from several hundred dollars for a PC to several thousand for a server, while there's no such charge for Linux. The total cost over three years for a small server used by 30 people, including licensing fees, support, and upgrade rights, would be about \$3,500 for Windows, compared with \$2,400 for a Red Hat subscription, say analysts. The situation where Microsoft can have an edge is when a company already is using Windows. Then, in some cases, it can be cheaper to upgrade to a newer version of Microsoft's software, rather than replacing it with Linux—once you take into account the retraining expenses. Analyst George Weiss of market researcher Gartner Inc. says that Microsoft may trumpet those individual cases, but "there's no study that says Windows will be a better total cost of ownership in general."

Microsoft isn't shying away from brass-knuckle tactics in an effort to win this battle. Several sources say that its executives

have been warning corporations that they're taking a leg by using Linux. A spokesperson for one company whose met with Ballmer says the implication of their conversation that Microsoft is considering suing outfits that use the software and claiming that it infringes Microsoft patents. Although experts doubt Microsoft would actually sue its own customers, Linux supporters say such warnings are an effort to sow doubt and uncertainty. "Our friends in Redmond [Washington] are rattling their swords. They're trying to scare people into switching from Windows to Linux," says Jack Messman, a Linux distributor Novell. Microsoft acknowledges discussing legal risks with customers but denies trying to intimidate them. It won't say whether it believes Linux infringes on its patents.

COMMUNAL IMPULSES

THAT LINUX IS MORE than holding its own against Microsoft's onslaught suggests it could become a model for others in the tech industry. Otherwise fierce competitors—think IBM and Hewlett-Packard—are demonstrating that they can benefit from embracing the open-source philosophy of sharing work. By collaborating on the operating system, they all get a stable platform on which to build tech projects and save millions in programming costs. "Much software will be developed this way. It's especially good for infrastructure—stuff that affects everybody," says Torvalds. "In the long run, you can't sanely compete with the open-source mentality."

Linux Inc. has become so mature that it's clear it could continue to thrive even without Torvalds. Already his chief lieutenant, Andrew Morton, shares leadership duties and makes the public appearances. From 1997 to 2003, when Torvalds worked for chipmaker Transmeta Corp., putting out Linux wasn't even his full-time job—yet its market share in servers rose from 6.8% to 24%. Plus, this isn't the army: Programmers don't wait around for orders. Linux' legions know how the development process works, and they just do it. "I manage people but not in the traditional sense," says Torvalds. "I can't say, 'do this because here's your next paycheck.' It's more like, 'I know what we want to do, but we don't know how to do it, so try directions. Sometimes somebody disagrees and has a veto. They go and sulk in their corner for a year. Then they come back and say, 'I'll show you it's much faster if you do it this way.' And sometimes they're right."

This mix of commercial and communal impulses has its roots in the early days of personal computing. Academics and corporate researchers originally shared many of their software innovations. But that started to change in the 1980s as the industry took shape. In response, programmer Richard Stallman launched the Free Software movement. His answer: the GNU operating system, modeled on Unix, that was shared by a community of programmers.

It was Torvalds who came along with a piece of software called the kernel, which is the control center of the operating system and coordinates the work of other pieces, such as software that tells the printer to produce a page. Programmers called the kernel "Linux," a contraction of Linus and Unix. Linux caught on as the name for the whole thing. Torvalds decided the group's mascot should be a friendly penguin, named Tux, partly because a pint-size Fairy penguin once nibbled his finger at an Australian

Stallman is still an evangelist for free

Sea Change The culture at Linux is cooperative, meritocratic, and Darwinian at the same time

out with his wild long hair and odd behavior, he doesn't fit the suit-and-tie crowd. He doesn't even speak to Torvalds—since Torvalds decided to use a piece of software that open-source to help develop Linux. “The place he wants people is a mistake. It isn't to freedom,” says Stallman of ls. During speaking engagements, Stallman often adopts sona of “St. GNUcius,” donning a robe and a halo made computer disk. Chris Wright, a young programmer for recalls a group dinner at a restaurant where the trade hosted Stallman. Wright was impressed with Stallman's but put off by his style. “He wanted to taste everybody's o it was a little awkward,” says Wright.

alds proved to be just the guy to lead the Linux charge. s only a casual programmer in 1991 when he started writ- ftware to run on a PC. But after he posted the first Linux n the Internet for others to contribute to, he got the knack otting quality and handling the flow of fixes. Gradually, he ped a support organization of volunteers.

run as a meritocracy, Linux continues to operate that way.

In a world where everybody can look at every bit of code that is submitted, only the A+ stuff gets in and only the best programmers rise to become Torvalds' top aides. “The lieutenants get picked—but not by me,” explains Torvalds. “Somebody who gets things done, and shows good taste—people just start sending them suggestions and patches. I didn't design it this way. It happens because this is the way people work naturally.”

One reason that Linux Inc. bears little resemblance to a traditional company is that Torvalds has almost nothing in common with classic, hard-driving, and autocratic tech-industry leaders. He rarely appears in public and largely lets other people set priorities for development. Once others come up with improvements, he shepherds them along. “Linus has power, but he doesn't have it by fiat,” says Havoc Pennington, a Linux contributor who works for Red Hat. “He has power because people trust him. As long as he keeps making good decisions, people won't take it away from him.”

Yet for all of his seeming passivity, Torvalds is a strong leader. He stays scrupulously neutral, never taking one company's side

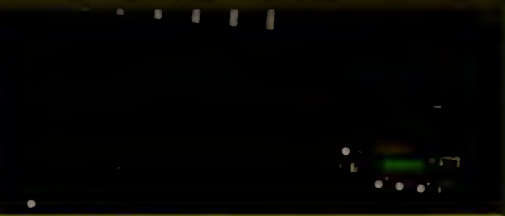
WHERE'S LINUX?

might as well ask: Where's Waldo? Linux is almost everywhere. ause it was designed from the ground up to be the Swiss Army e of operating systems, it can be easily adapted to many uses.



VEHICLES

It's a brand-new thing. Sony uses Linux in one of its on-board auto-navigation systems in Japan. Volvo uses it in systems that track buses and trams for commuters in Sweden.



SERVERS

Linux is the No. 2 server operating system, running everything from small networks at the neighborhood copy shop to mega-Web sites such as Google and eBay. Google taps an estimated 100,000 Linux computers for its search service.

1. Alias (ABC7)
2. The Daily Show With Jon Ste
3. American Idol (FOX)

SET-TOP BOXES

able-TV offerings get more sophisticated, ators are using computerlike set-tops. boxes used by Cablevision in the York metropolitan area run Linux. Ditto TiVo's onal video recorder.



ROBOTS

The system is turning up in everything from outer space rovers to mechanical domestic servants. Wakamaru, developed by Japan's Mitsubishi Heavy Industries, is an experimental robot capable of being a caretaker and house sitter.

CELL PHONES

manufacturers of lar telephones shift to dard operating systems, x is a prime candidate. dy it's running e of the new mobile es that are being put out torola.



DESKTOPS

Programmers at hundreds of companies use Linux on their PCs, and now large corporations are considering switching over. AT&T is thinking about swapping out Windows in favor of Linux for 70,000 employees.



SUPERCOMPUTERS

In the past five years, Linux has become the operating system of choice. It's used in a host of applications, from car-crash simulations to NASA's new Columbia space-exploration simulator. The Columbia is one of the the world's fastest supercomputers, powered by 10,240 processors.



over another. He focuses on the open-source development process. There, he demands high-quality work. Things must be just so, with the least amount of coding. As a result, Linux has few errors that can be exploited by virus writers. That gives it an edge on Windows, which has become a favorite target of hackers—largely because it's so widely used, but also because it has vulnerabilities that Linux doesn't. "He has set a compelling vision and inspired people to follow it," says Larry Augustin, a venture capitalist at Azure Capital Partners and an OSDL board member: "It's leadership by example, rather than leadership by hype."

Even today, Torvalds operates in a virtual world of e-mails and Web sites. He works almost entirely from a roomy house that sits on a wooded Oregon mountaintop and is decorated with taxidermic specimens, including a piranha and a crocodile. He gets up early, making strong cups of coffee for himself and his wife, Tove, a former karate champion in Finland. Then he settles in for hours of reviewing code and snapping off e-mail messages in his basement office. It's lined with science fiction and fantasy books, including classics such as *Dune* and the *Wheel of Time* series. In the afternoon, he coasts down the hill on his bicycle to a quaint village, stops at a Peet's coffee shop for a latte or Chai tea, and pumps back up the hill. Then he returns to his computers.

Although Torvalds is physically near his comrades at OSDL, he almost never sees them face to face. He visited the organization's office only once in his first three months in the Portland area, and he rarely meets with Morton, an Aussie who lives in Silicon Valley. "It's a long-distance mind-meld," says Morton. In a rare encounter last summer, they shook hands and made small talk at a picnic. The Linux community, Torvalds says, is like a huge spider web, or better yet, multiple spider webs representing dozens of related open-source projects. His office is "near where those webs intersect."

Sharing There is no conflict so far, says Novell's de Icaza. "Cooperating gets you further along than screwing your neighbor"

The Linux development process and ends with the programmers; there are still some individual volunteers and government agencies that chip in, but 90% of the patches now come from employees at tech companies. Many of those are formerly independent developers who have been scooped up over the past few years. Some of these people simply submit patches, and others, called maintainers, are in charge of improving specific functions.

From there on, it's a continuous cycle: Individuals submit patches; maintainers improve them. Then they're passed on to Linus Torvalds and Morton, who review

patches, ask for improvements, and update the kernel. Every four to six weeks, Torvalds releases a new test version. Every few months, thousands of people around the world can probe it for flaws. Torvalds puts out a major upgrade every three years or so. Unlike traditional software companies, there are no deadlines. The kernel is done when Torvalds decides it's ready.

Linux Inc. is a series of concentric circles radiating out from Torvalds. In the first circle, you have Open Source Development Labs. The top tech companies with a stake in Linux—including HP, IBM, and Intel—have technical people on the board of directors. The board sets priorities, such as getting Linux running better for huge data centers and desktop PCs. In addition, the board is responsible for raising \$10 million to protect developers from potential intellectual-property claims.

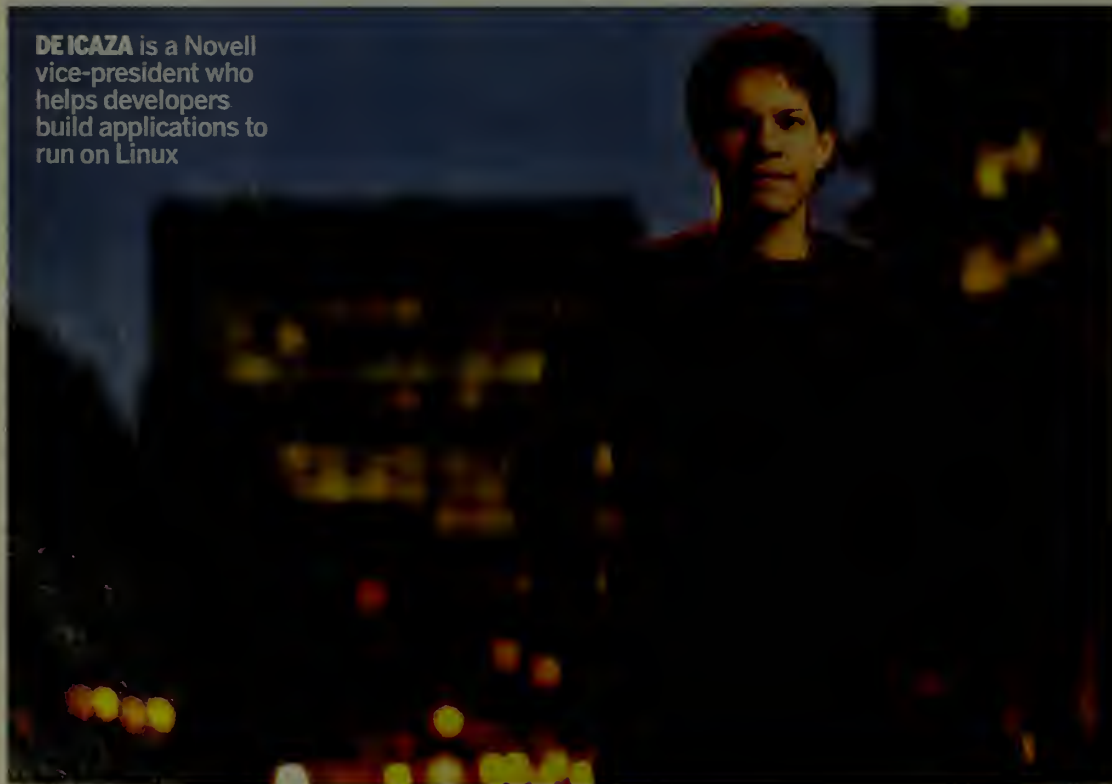
TAKING THE SUBWAY

THE SECOND CIRCLE is a dozen or so Linux distributors. Headed by Red Hat and Novell, this group also includes several regional players as Red Flag Software in China and Manjaro Linux in Europe. They pick up the latest version of the kernel about once a year and package it with 1,000 or so related

source programs, including the GNOME graphical user interface, the Firefox browser, and the OpenOffice document application suite.

The distributors race to be first out with Linux updates, but the engineers spend most of their time on projects they share with everybody. For example, Novell employs open-source pioneer Miguel de Icaza, who is both a Novell vice-president and the leader of the Mono project—software for building applications that run on Linux. The 34-year-old Mexican coordinates Novell employees plus more than 300 other programmers, many of whom work for other tech companies. So far, de Icaza says, there have been no conflicts. His explanation: "Cooperating gets you further along than screwing your neighbor."

DE ICAZA is a Novell vice-president who helps developers build applications to run on Linux



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The one thing they all have in common? The shared knowledge that helping to keep an employee's family safe is – without a doubt – one of the most valuable benefits their company can ever offer. To learn more, visit theantidrug.com/atwork

HOW TO PROFIT FROM FREE SOFTWARE

IBM, Red Hat, and other tech companies pay the salaries of programmers to help improve the Linux operating system. Here's what they get out of it:

LINUX DISTRIBUTORS

While people can obtain basic copies of Linux free of cost, distributors including Red Hat and Novell charge annual subscription fees, ranging from \$35 for a desktop version of Linux to \$1,500 for a high-end server. The reason such customers are willing to pay? Those packages come with instructions, free updates, and customer service.

COMPUTER MAKERS

Companies such as Dell, Hewlett-Packard, and IBM sell PCs and servers preloaded with Linux. They capitalize on the ability to sell machines without an up-front charge for the operating system, which can total thousands of dollars. For HP, Linux sales accounted for 18% of its \$15.4 billion in server revenues last fiscal year, up from 10% three years ago.

SOFTWARE COMPANIES

A swarm of software companies sell products that run on top of Linux. About 10% of giant SAP's corporate-application sales are derived from Linux-related products. In addition, upstart MySQL makes a database that runs on Linux and already has reached 6 million installations, including at powerhouses such as NASA and Net-search giant Google.

ing gets you further along than screwing your neighbor.”

These Linux companies have little in common with their brethren from the dot-com boom. They're typically frugal. Matthew J. Szulik, CEO of Red Hat, takes the subway rather than a cab when he visits customers in New York and Boston. And rather than being motivated by big money, Linux programmers say their goal is making Linux an ever-bigger force in computing. Red Hat's Pennington doesn't covet expensive wheels, proudly pointing to his 2001 Toyota Corolla in the parking lot, which he jokes is “fully loaded.”

For his part, Torvalds has been amply rewarded for his role, but he's no Bill Gates billionaire. OSDL pays him a salary of nearly \$200,000. In addition, he sold initial public offering shares that he got as gifts from a couple of Linux companies, including VA Linux Systems. That helped him afford his house and put money away for his daughters' educations.

ALL-PURPOSE SYSTEM

IN LINUX SOCIETY, there's no bowing and scraping before the rich and powerful. Executives and product managers at HP, IBM, Intel, and Oracle don't even try to pressure Torvalds and Morton to further their interests. Instead, their input goes through their engineers, who, as members of the open-source community, submit patches for the kernel or other pieces of Linux software.

The tech powerhouses have learned to play by new rules. You can't meet in private, come up with new features, and then drop massive changes on Torvalds. A handful of companies, including Intel and Nokia Corp., learned this lesson the hard way when they went about making Linux capable of running telecom gear. About two dozen of their engineers worked on the “carrier-grade” Linux project, and then, in late 2002, they posted hundreds of thousands of lines of code on a Web site. The response: outrage. “We were offended by the whole process,” says Alan Cox, a top kernel programmer. The posting was quickly removed.

Still, the cultures of open-source and commercial software are melding together. Red Hat used to scatter employees around the world, the typical open-source approach. Now the company brings its workers together so young programmers can cross-pollinate with gray-haired veterans. It works. Not only did 46-year-old Larry Woodman bond with 26-year-old Rik van Riel by teaching him how to drive a car, but the two are working in tandem on im-

provements to memory management in Linux. “We complement each other,” says Woodman.

These collaborations are turning Linux into an all-purpose operating system. It's secure enough that Lawrence Livermore National Laboratory loads it not only on desktop and server computers but also on supercomputers it uses to simulate the behavior of nuclear materials. “Linux is definitely more secure than Windows,” says Mark Seager, the lab's assistant department head for advanced technology. “There aren't as many ways to break into a Linux system.” With the latest improvements, Linux now works on servers with more than 128 processors and can run the largest databases. The newest versions also have features, such as power management, that make them more suitable for laptop use.

Linux is so solid that staid corporate purchasers are adopting it aggressively for run-the-company applications. Holding the Swiss cement giant, just switched from Unix to Linux for some of its accounting, manufacturing, and human-resources applications. The attraction: 50% savings on hardware, 20% on software. “It was a no-brainer to go with Linux,” says Carl Wilson, chief operations manager for the company's American data center.

Cost isn't the only reason that companies are switching to Linux. The data processor Axciom Corp. recently shifted from Unix servers to the operating system, after using Unix in the past. Alex Dietz, the company's chief information officer, says he was thinking about replacing the Windows operating system with Linux on the company's desktop computers. One important reason: Axciom doesn't want to be too dependent on Microsoft. “[Linux] has an innate guarantee that you won't be taken hostage,” says Dietz.

Torvalds takes tremendous satisfaction in seeing his creation grow up. “It's like a river. It starts off a bouncy small stream and turns into a slower-moving big thing,” he says.

Melding The worlds of open-source and commercial software are coming together, as young programmers learn to work with veterans

Indeed, Linux Inc. has emerged as a new model for collaborating in a new era of software development, which could have reverberations throughout the business world. Its essence is captured in one of the mottoes of the open-source world: Give a little, take a lot. In a business environment where efficiency is king, that's a potent formula—maybe strong enough to knock mighty Microsoft down a peg. ■

BusinessWeek online For a Q&A with Microsoft's Kevin Johnson, head of sales, go to www.businessweek.com/extras

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*Components and vehicles are made using many U.S. sourced parts. ©2005

Far from the Madding Crowd

Take the home equity and run inland, say city dwellers on both coasts

ONLY A YEAR AND A half ago, Debbie Rubenstein and David Flynn felt like the commuting dead, slogging three hours round-trip from their home in Maplewood, N.J., to day care for the baby, their offices in Manhattan, and then back again. Debbie, 36, made documentaries for PBS. David, 32, worked as a software developer at TIAA-CREF. Weekdays, they barely saw their 18-month-old daughter; weekends, they barely saw each other. They passed off Samantha like a baton, alternately sprinting through the relay of grocery shopping, dry cleaning drop-offs, and gas tank fill-ups. "We were working all the time just to afford to keep living where we were living," says Debbie. Neither a second child nor an executive MBA for David fit into their 5-, 10- or even 20-year budgets. Thoughts of another terrorist attack plagued them: Trapped in Manhattan, how would they get to Samantha, marooned in day care across the Hudson?

The answer came in the gold mine they were sitting on: the three-bedroom, cen-

ter-hall colonial that had appreciated 50% in the three years since they bought it. In September, 2003, they sold the house for \$505,000, plowed the gains into a jumbo downpayment on a Craftsman bungalow in a posh enclave in downtown Charlotte, N.C., and slashed their fixed expenses by nearly 75%.

VALUE-PRICED REGIONS

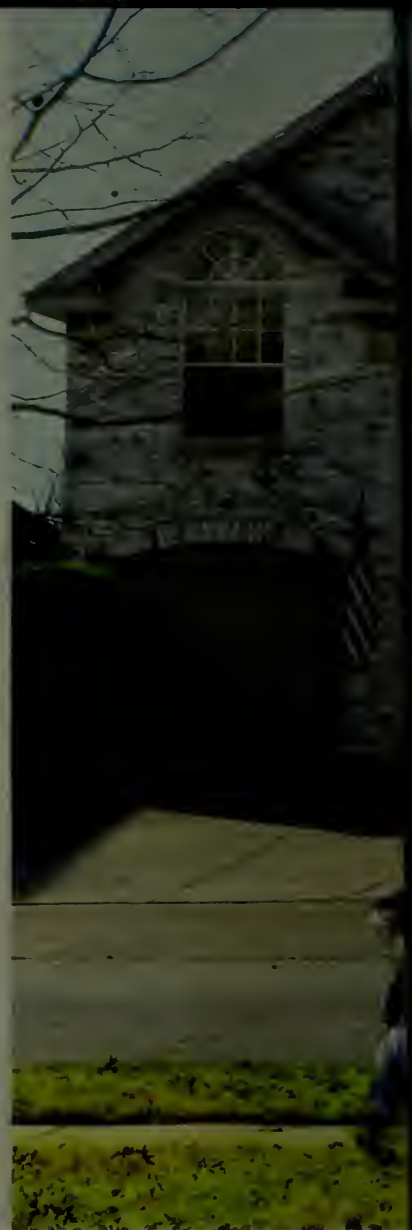
IN DOING SO, they became one of a growing group of real estate vanguards: the equity refugees. Their mortgage and taxes have plummeted from \$2,600 a month to \$850. Day care is down from \$1,260 a month to \$550. Debbie's commute to her home office, out of which she still does documentaries, takes five seconds. David's trek to TIAA-CREF, which reassigned him to Charlotte, is 20 minutes each way. In early January, Debbie gave birth to a second baby girl, Rachel. David is applying for executive MBA programs. They have also become refugees from tension, now spending weekends doing things like picking pumpkins and visiting horse farms. "We have dinner together every night," says Debbie. "I don't know a single married couple in New York who is able to do that."

With housing prices on both coasts at nosebleed levels, more and more professional-class migrants are cashing out of their homes in New York, the Bay Area, and Los Angeles as though from premium-heavy dot-coms. Motivated by favorable capital-gains rates, fears of a housing bubble, and worries of a sideways stock market over the next decade, they are moving to value-priced regions of the country, creating tiny pockets of blue

America in the heart of the red (table). Experts are calling the trend geographic arbitrage."

With soaring health-care and other costs also pounding the middle class, demographers such as the Brookings Institution's William H. Frey predict waves of inland migration. The price between urban coastal areas and the rest of the country is at an historic high. At the same time, the information gap is shrinking: The new wireless world, even in rural towns, is allowing more people to long-distance relationships with employers, working remotely from anywhere. That means more people might be able to live in the cheap places but still get as though they live in the expensive ones.

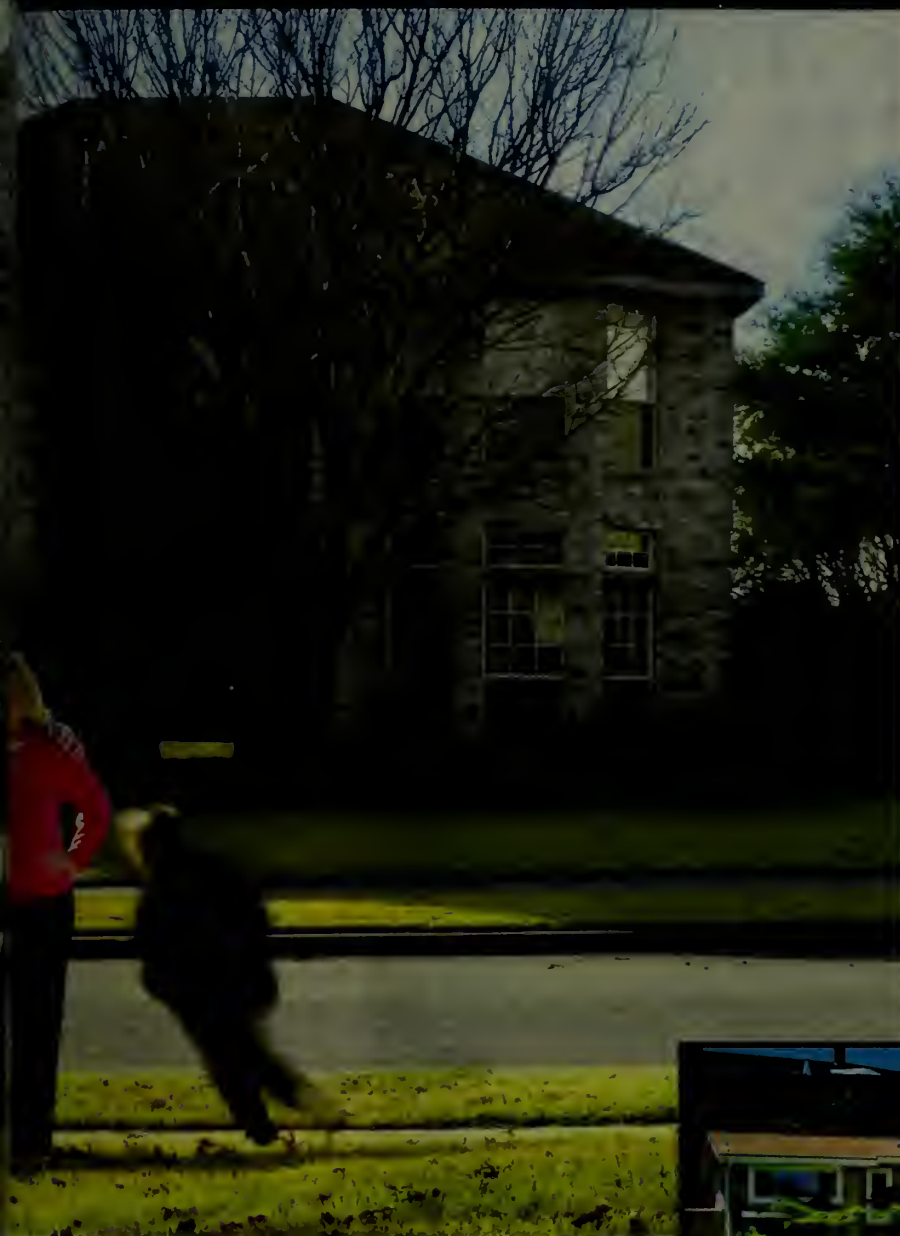
The moves are also a response to mounting personal debt, battered p



Migration Magnets

People are cashing out of metro areas such as NYC, L.A., and San Francisco, where real estate prices are at nosebleed levels, and moving to more affordable locales. The top metro destinations:

1. Phoenix
2. Las Vegas
3. Atlanta
4. Dallas-Fort Worth
5. Tampa-St. Pete



DALLAS PALACE

The Kornegays' new digs, vs. their old San Diego box

moved out of state during the second quarter of 2004—many to cheaper communities—vs.

23% during the same period in 2003.

For some thirty- and fortysomethings, the *Extreme Makeover: Home Edition* glorified lust for all things house-related stirs desires to trade up—yet they can't afford to do so in their neighborhoods. Shawn Shook Kornegay and her husband wanted to upgrade beyond the 1,200-sq.-ft., low-curb-appeal ranch they shared with their 6- and 7-year-old sons in San Diego. But they encountered a parade of overpriced dumps with filthy carpets and features such as tangerine linoleum and avocado appliances. One "four bedroom" for \$675,000 looked promising—until they discovered that two of those bedrooms were located in the garage. They ended up selling their house for \$480,000 and using the \$318,000 profit to start a college fund, pay off bills, fatten their retirement accounts, and buy a 3,400-sq.-ft. starter castle in Dallas with five bedrooms, a pool, jacuzzi, cabana, two fireplaces, and new furniture. Price: \$241,000. Instead of their crumbling San Diego school with no air conditioners, the boys now attend a top-rated



insufferable traffic, and angst-producing status competition. Some simply want to retire. For others, the prospect of the housing market is too tempting to resist. Valerie Bent and her husband sold their 2,200-sq.-ft. house in Simi Valley, netting \$300,000 in 2003. They then bought a 5,500-sq.-ft., Mediterranean-style showplace in Las Vegas for \$900,000. It's now worth \$900,000. Retirees have been migrating to the desert for years. "What's different now is the phenomenon of people still in the middle of their work careers, uprooting themselves," says P. Retsinas, director of Harvard University's Joint Center for Housing Studies, which is conducting a study of the trend. It also means that real estate is going to change the shape of the work-

force, affecting the flows of the professional class. Eventually, says Retsinas, the migrations of the equity refugees could start to even out housing prices across the country and create a talent exchange as knowledge workers disperse from the coastal cities to places such as Phoenix, Las Vegas, and Atlanta.

TRADING UP

ALREADY, IN LOS ANGELES so many homeowners are moving to Nevada and Arizona that the waiting time for moving vans is often a month. In fact, one-quarter of Californians say the high cost of housing is forcing them to consider moving, according to the state's Public Policy Institute. About 42% of home sellers over 55

K-6 in a state-of-the-art building.

The transplants have their misgivings, though, ranging from sushi-delivery deprivation to political alienation. Some regret moving but have already gotten priced out of the places they want to return to. Incomes and benefits can be hard to replace for those who quit jobs. There's also often a social price to be paid in isolation, nonexistent career networks, and lost friends.

Still, becoming an equity refugee is something demographers say more and more may consider, especially since it's one of the few ways to transform the "balance" in the work-family equation from a Sisyphean campaign into something approaching reality. ■

—By Michelle Conlin, with Timothy J. Mullaney, in New York

lando 7 Sacramento 8 Austin 9 Charlotte

Data: William H. Frey, Brookings Institution

COMMENTARY

BY HOWARD GLECKMAN

The Real Retirement Time Bomb

Without reform, Medicare premiums will eat away at Social Security benefits

WHILE WASHINGTON politicians squabble over the fate of Social Security private accounts, they seem to have contracted a capitalwide case of amnesia about a much bigger problem: Medicare. Yet an analysis done for *BusinessWeek* by Urban Institute researchers Richard W. Johnson and Melissa Favreault found that by 2040, if

health-care costs continue to climb, typical retirees could be paying nearly 22% of their Social Security benefits for Medicare premiums. And that's if they get the full checks promised by current law.

Of course, today's thirtysomethings may never collect on all of those promises. President George W. Bush's drive to reform Social Security is based on projections that the system will fall trillions of dollars short of its obligations (BW—Jan. 24). The possibility of diminished benefits, coupled with spiraling medical costs, means that future retirees could find themselves with less money for food, housing, and other basic living expenses.

Under current law, a typical retiree in 2040 can expect \$1,335 a month from Social Security in today's dollars. But they will pay \$292 for Medicare, leaving \$1,043. The President has not yet said how he would trim Social Security benefits. But in 2001, a Bush-appointed commission proposed a change in the way initial benefits are figured. Under that plan, the same senior would receive \$1,077 a month from Social Security and still have to pay \$292 for Medicare—27% of their monthly check. That would leave a retiree who has no other income with just \$785 a month for food, transportation, housing, and taxes. And seniors would still face rising out-of-pocket medical costs, such as co-payments, deductibles, and additional premiums for supplemental Medigap insurance.

Today, low-income workers get nearly 90% of their retirement benefits from Social Security, though in the future, many seniors will have other income. If the Bush commission plan

were enacted, they would have private accounts—although like basic benefits, the accounts would rise and fall with markets. Many retirees will also have modest pension or retirement plans such as a 401(k). But unless a typical retiree's savings increase sharply, pensions and 401(k)s are unlikely to produce more than \$1,000 a month in today's dollars before taxes.

Where will all the money go? Today, seniors pay a premium for Medicare Part B, which covers doctor visits, lab tests, and outpatient hospital care. In 2005, that payment is \$7 a month, taken directly out of Social Security checks. Starting in 2006, most seniors will also be paying an estimated \$12 a month for Part D, the new drug benefit.

The trouble is, with medical costs skyrocketing, premiums

are expected to rise sharply in coming years. The Urban Institute study assumed modest future increases—just 3.2% annual growth. In fact, Medicare premiums have been rising much faster than that in recent years—17.5% in 2005 alone.

Make no mistake, future retirees will be getting plenty of care, but at a cost. For instance, a couple now 40 years old and only to start collecting Medicare in 2030 can expect to receive a total of \$665,000 in lifetime Medicare benefits after they retire, according to Urban Institute senior fellow Eugene Steuerle.

That's why the government's projected Medicare shortfall is much larger than that of Social Security. Explaining the long-term care costs for seniors is also why Medicaid—already cutting state budgets—is expected to rise sharply in coming years.

But government won't pick up the whole tab for seniors' care unless something changes, future retirees will have to accept major reductions in their standard of living in exchange for health insurance.

That's a trade-off that seniors may choose to make. But it should be decided with its eyes open, far, when it comes to the critical link between Medicare and Social Security, both parties in Congress and President Bush have been moving forward with their eyes wide shut. ■



Will high Medicare costs lower living standards for seniors?

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COMMENTARY

BY LAUREN GARD

Free Press Gets a Whole New Meaning

Giveaway papers are attracting younger readers and bringing in new advertisers

WHEN THE New York Times Co. announced plans on Jan. 4 to ante up \$16.5 million for a stake in a free Boston daily newspaper, it validated a strategy others had launched as far back as five years ago. *The Washington Post*, *Chicago Tribune*, *Chicago Sun-Times*, and *The Dallas Morning News* have all jumped into the free-daily fray, hoping to beat competitors as they go after a younger readership and the coveted advertisers that come with it (page 94). Many more, wisely, are expected to follow. "When the *Times* sneezes," says Earl J. Wilkinson, executive director of International Newspaper Marketing Assn., "everyone catches a cold."

Getting into the free business is a smart and necessary strategy for a graying industry. A few telling statistics show the huge void left by the exodus of young newspaper readers. In 2004, just 39% of 18-to-24-year-olds flipped through a newspaper on any given day—down from 59% two decades earlier. And only 17% of daily newspaper subscribers fall into that age bracket, according to a 2002 Newspaper Association of America study. Meanwhile, estimates for total spending on newspaper advertising in 2004, about \$46 billion, are still shy of a peak of \$48 billion in 2000, says the NAA. Clearly, the industry's ad slump has been exacerbated by newspapers' failure to hang onto the readers Madison Avenue cherishes most.

It's not like they haven't tried. But bulking up entertainment and sports coverage and adding educational outreach programs and special supplements have had little effect. If would-be readers crave news, they most often hop online now, it seems, grab one of the free dailies. Today roughly 100 daily papers target youth—all popping up in the past five years, estimates the NAA. The tabloid-formatted papers with snappy stories, lots of celebrity chitchat, and heavy dog-eared graphics play well to members of Generations X and Y. Of course, the price is right: Hawkers at subway and bus stop on street corners put newspapers right into their hands.

Diving into the freebie biz may seem like desperation, but it turns out it's nothing to sneer at. The move draws in new advertisers, from local auto dealers to special cell phone promotions. The giveaways provide the big papers with a scrappy brand that allows them to deliver a young audience to advertisers without the counted rates or packaged offers. That allows the main newspaper to stay the course, without having to tinker with its ad rates. Merrill Lynch & Co. publishing analyst Lauren Rich Finck says having two kinds of properties "ends up being additive."

Advertising Mecca

IT'S UNCLEAR HOW MANY OF THE FREE newspaper giveaways are profitable so far, but the flow of ad dollars is steady. Below says its 15-month-old freebie *Quick* in Dallas has attracted about 200 advertisers that never bought space in its *Dallas Morning News*, accounting for 15% of *Quick*'s total ad revenues. *Metro Boston*, the paper the New York Times Co. is launching up with, reported revenue of \$10 million in 2004, not far from a free distribution product, says newspaper economist



Why Give It Away?

Big newspaper publishers are launching or are partnering with free newspapers.

THE RATIONALE:

YOUTH MOVEMENT Readership among 18-to-24-year-olds has dropped 55% over the past 20 years. Publishers hope giveaways will be habit-forming, transforming them into paying customers.

NEW REVENUES A free paper targeting Gens X and Y lures new advertisers that might then spend in the publishers' other papers.

THE RISKS:

A BAD HABIT Readers getting their news fix for free may never migrate to paying status and paid subscribers might go free instead.

THE DUMBDOWN Aiming content at quick-hit stories and younger readers could end up watering down the quality of journalism.

Data: BusinessWeek, W.R. Simmons & Associates, Scarborough Research

ART.

A LANGUAGE THE WORLD UNDERSTANDS.



In Bloom ALEKSANDR M. GERASIMOV 1930

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Grove. Still, adds Merrill's Fine, "it's more of a beginning than anything."

The endgame, though, is to get young readers into the daily paper groove so they'll yearn for a more grown-up product and open their wallets for a subscription. Converting fans of free dailies into paying customers is a tough proposition. Exhibit A: the music industry, in which a deep slump in sales followed the rise of free online file-sharing. There's even a chance that the reverse could also occur—that folks will swap their subscriptions for a free ride. But so far there has been little cannibalization of paid newspapers. Piet Bakker, University of Amsterdam researcher who has been tracking free dailies for six years, says he sees scant evidence that readers are dropping subscriptions for the free product.

Bare Bones

QUALITY MAY BE a concern, too. Can papers with bare-bones operations uphold the high journalistic standards expected of traditional dailies? Editorial models vary widely. Some rely on the repackaging of stories from a parent paper, others run wire stories, and some emphasize original reporting. "Our philosophy is the same as the New York *Daily News* or the New York *Post*," says editor Alex Storozyński, who manages two full-time reporters at Tribune Co.'s *AMNewYork*. "We do investigative journalism. We try to beat other people on stories." Still, some worry about a "dumbed down" freebie hurting a parent paper's reputation, though analysts say there is little to fear. "I believe the public understands only the single brand name of a paper," says newspaper consultant David M. Cole, adding that most readers won't remember that The Times owns part of *Metro Boston*.

Cities with mass transit in place are the biggest targets so far for the giveaways. But other commuter markets aren't far behind. Billionaire investor Philip F. Anschutz is set to launch the free daily *Examiner* in Washington D.C. on Feb. 1, using a traditional door-to-door delivery model. He has licensed the name in more than 60 other cities.

With young audiences increasingly distracted by everything from souped-up cell phones to Internet Web logs, publishers need to start thinking of freebies as another critical platform. Now that they're catching on, can a new category for the Pulitzer be far off? ■

Can VW Find Its Beetle Juice?

It is betting on new models—and an ad blitz—to rescue sagging sales

WHEN VOLKSWAGEN of America engineered a mid-1990s comeback, it did so amid a national love-in over the New Beetle and tons of attendant free publicity. But today, VW is trapped again by sliding sales and dismal reliability scores and has to rely on cash rebates to move cars. As VW embarks on its latest comeback try, the question is whether the company can restore its edge.

For five years, VW has littered the roadways with disgruntled owners. Models grew stale as management was distracted by an effort to market new luxury models that were priced between \$40,000 and \$100,000—far afield of VW's core image as an affordable German driving experience. As a result, U.S. sales, which are crucial to the German parent company, fell 15% last year and are off 28% from 2001—a decrease of almost 100,000 vehicles. Sales of the New Beetle are half what they were in 2000. Aggravated by the weak dollar and heavy rebates, VW lost more than \$1 billion in the U.S. last year.

The road map for this latest comeback try is far from certain. For the first time in seven years, VW is updating its bread-and-butter models: Jetta, Passat, GTI, and Golf. The new models are bigger and better engineered in every respect, from

computer-enhanced steering to better cup holders. But by Volkswagen's own admission, this latest push will lack much of the passion that surrounded the rollout of the much-anticipated New Beetle in 1998. "We need for the VW brand more emotion, as far as product is concerned and as far as the organization is concerned," says Volkswagen Chairman Bernd Pischetsrieder. Last year he scuttled plans to build an updated but costly version of the Microbus, which might have generated another torrent of free media. Jetta and Passat, arriving in 2002, are comparative wallflowers—shy four-door sedans that will also be offered as wagons. The 197-hp GTI, due in 2003, is a low-volume, high-performance version of the standard Golf. And a low-volume version of the Golf, which struggled against Japanese rivals, arrives in spring, 2006.

Lacking a new "retro" model to whip up interest, VW is counting on a renaissance of its advertising. Starting in the 1960s, VW ads defined a generation of Madison Avenue writers. Seven years ago, Boston agency Arnold Worldwide became the toast of Madison Avenue with 30-second ads that played more like short-form cinema and ended with what would later become

Getting **VW** Back in Gear

The German carmaker is racing to recapture its edge:

NEW VOLKSWAGENS

Redesigned versions of the Jetta, Passat and Golf arrive in the new lineup. The Touareg SUV was well received, but the sedan got panned. The bloated all-new Beetle. There's no van or budget SUV in



RED-HOT GOLF

New cars roll off a turntable at VW's plant in Wolfsburg

sedan, which is now on its way to becoming an international bust. All that while the Jetta, Golf, and Passat languished without up-

dates. "One of our buyers could have leased the exact same Jetta three times on two-year leases," sighs VW's U.S. chief, Len Hunt. Hunt, on the job for almost a year after engineering a turnaround at VW's Audi of America unit, vows that henceforth all VW models will get substantial facelifts every three or four years, the way Honda does it. Even so, a much-needed budget-priced SUV and van won't arrive until 2007.

At Audi, Hunt drove an improvement in product, quality, and dealer service. Even though Audi sales were down last year, it was primarily due to the weak dollar and last sales of old A6 and A4 car models. New versions of those vehicles were launched to positive reviews in October and early this year. To improve quality, Hunt spurred the creation of "quality circles" that got U.S. and German executives together monthly to translate customer beefs into faster improvements on the assembly line and in future products. Hunt also had J.D. Power & Associates Inc. rigorously test preproduction VWs to weed out glitches that sink the quality scores. Now he's bringing the same tactics to VW, which languishes near the bottom of J.D. Power's rankings for reliability and service.

But even if all VW's reforms take hold, it is likely to take years to restore trust to the brand. "A lot of those customers drawn to VW as an island in a sea of mediocrity in the 1990s feel burned," says analyst John Wolkonowicz at Global Insight Inc., a Waltham (Mass.) research firm. Meanwhile, Toyota, Nissan, and Honda have only gotten better. And General Motors, Ford Motor, Chrysler, and Hyundai have been improving quality and flooding the market with new models that reflect their study of VW's craftsmanship, especially its interiors. VW, which celebrates its 50th anniversary in the U.S. this year, has proved resilient. But this time around, the trick is not to show its age. ■

—By David Kiley in Detroit

crowd. "VW ads led the way in integrating the coolest alternative rock music commercials, and to those in the know about the music it became like a cult." Says *Adweek* ad critic Barbara Lipman, among the spots that resonated with the "slacker" ethos, showing two men driving a Golf around town to the underground hit *Da, Da, Da* by the Roots. That work is a tough act to follow. Says Pafenbach, Arnold's creative director at VW, admits the company's ad campaign "the elephant in the room that you don't want to look at because, if you do, you have to concentrate on what you are doing." Without a big publicity generator this year, VW will have to pay for its buzz. In 2004, it announced a \$200 million advertising campaign with NBC Universal Inc., on top of its \$100 million media budget, to weave VW models into films, TV shows, and theme parks. Sinking all that cash into main-

stream media venues seems at odds with VW's counterculture image, what Pafenbach describes as "a club for people who don't join clubs." To tap back into the Generation X crowd that flocked to VW in the late '90s, VW will screen a seven-minute film at this month's Sundance Film Festival, starring actors Joe Pantoliano (Ralphie from *The Sopranos*) and Kevin Connolly (Eric in HBO's *Entourage*). The story, to be distributed over the Internet, involves people trying to hang on to their souls while jobs and family responsibilities tug at them.

A FRESH LINEUP

MARKETING PLOYS ASIDE, one of VW's biggest challenges remains its own lineup. VW still has just one sport-utility vehicle, the \$37,000-\$58,000 Touareg, which is selling well. But VW also lavished scarce funds on developing the \$68,000-\$100,000 VW Phaeton luxury



QUALITY

The VW brand evokes warm feelings for many consumers of all ages, but company management must overcome the cars' recent dreadful rankings from *Consumer Reports* and J.D. Power for quality, service, and sales experience.

ADVERTISING

Recent campaigns aren't as interesting as iconic spots of the '60s and '90s. VW is trying to bolster its buzz by moving big into product placements, weaving VWs into movies, DVDs, and theme parks. A new *Herbie the Love Bug* film arrives this summer.



Loading up On Junk

With IPOs slow, buyout firms are selling junk bonds to recoup lots of their cash

FOR YEARS AFTER THE STOCK market drop in 2000, private equity firms found themselves locked into their investments with little hope of getting their money out. Their usual exit route, an initial public offering, was effectively closed. But now a combination of cheap money, better corporate cash flow, and a hunt for higher interest rate yields by institutional investors, such as banks, insurers, pension and mutual funds, is providing them with a new escape hatch.

Private equity firms including Thomas H. Lee Partners, Blackstone Group, and

Kohlberg Kravis Roberts are increasingly taking big slugs of cash out of the companies they own by getting them to issue junk bonds and then use the proceeds to pay out big dividends.

This loads yet more debt onto companies that are often already highly leveraged, but it is proving irresistible to the firms. In December, for example, mattress maker Simmons Co. sold \$165 million of nearly distressed debt in the market and then paid out a special dividend to Lee and its partners. The sum returned is more than 40% of the \$388 million the group had put down just 12 months earlier when it purchased Simmons in a \$1.1

billion leveraged buyout. The deal is a long way toward making up for the loss when the Lee group failed to collect on its investment when it withdrew a planned IPO of Simmons after the equity market cooled. Lee still owns 100% of Simmons.

Such cash-out borrowings, more formally known as dividend recapitalizations, are surging in popularity. Last year, 77 dividends, worth \$13.5 billion, were financed by junk-bond market deals, up from 26 worth \$6 billion in 2003 and 19 worth \$2 billion in '02, according to Jim Casey, an investment banker in charge of the high-yield department at Morgan Chase & Co. Highly leveraged loans from banks raised another \$9 billion for dividends in 2004, three times as much as the year before, according to LCD, a unit of Standard & Poor's that tracks the leveraged loan market. "As a market develops like this, the bad deals all swarm in" to make deals, says a buyout executive.

Several factors are driving the demand. Demand for corporate debt is red-hot because yields on U.S. government debt are so low. In fact, demand for junk bonds is so intense that the interest-rate premium borrowers must pay over what they can earn by buying Treasuries is the highest in at least six years. Improving corporate cash flow is reassuring investors that borrowers will be able to repay loans.

the firms, the government's decision to raise taxes on dividends to the same rates as on long-term capital gains makes it easier to net a payout that is as good as it would be from an IPO.

But the deals come at a price. They pile on more debt, and more risk of default, on top of the fact that the equity firms leveraged themselves when they bought them in the first place. In fact, some observers believe that divestitures could become the hallmark move in the current bull market in bonds.

Martin Fridson, chief executive of Vision LLC, a high-yield market research service, says the deals are the prominent new source of supply that bankers have found to feed a new generation of yield-hungry investors. Lonski, chief economist at Moody's Investors Service, says that in 20 years of running the junk-bond market he has never seen so many leveraged payouts contributing to so many credit downgrades: 17 in the fourth quarter of 2004. "A significant number of these lower-rated companies will default within the next few years," says Lonski.

Naturally, bankers and private equity firms aren't so downbeat. J.P. Morgan's numbers counters that dividend payouts behind only 8% of the new junk bonds issued last year and a much smaller factor in today's market than were the leveraged buyouts and LBOs of past bull markets. And Lee co-president Scott A. Lee says his firm has taken advantage of the hot market to borrow only against the underlying businesses generating enough cash to eventually pay off the extra debt. "We take these opportunities without adding a lot of incremental risk to the companies," says Schoen.

HYBRID STRUCTURES

THE SAME, BANKERS and private equity firms know that to keep doing the deal and financing the payouts they'll have to be careful to control risk as they pile on debt. To do that, they've been coming up with increasingly complex securities to minimize interest payments in the early years of loans, thus postponing any days reckoning.

Consider the \$700 million package of debt issued on Dec. 23 by WMG Holdings Corp., parent of Warner Music Group, which was bought in a leveraged \$2.6 billion deal a year ago from Time Warner Inc. The group including former Seagram Co. CEO Edgar Bronfman Jr. and equity firms Bain Capital and Providence Equity Partners. One \$250 million slice of the debt offers a yield of 9.5% a year but with

no interest actually being paid for the first five years of its 10-year life. Holders of another \$200 million tranche of the debt won't get any cash payout until that part of the loan matures in 10 years time. In effect, buyers of the debt get to accrue interest before the company ever has to pay it. What's more, the new debt was issued through a holding company, so that it would have a weaker claim on the assets of the business

than the \$2 billion of debt Warner Music already carries.

The fancy structure in the Warner deal apparently helped because Moody's did not downgrade the company's existing debt. But Moody's did assign a negative outlook on it. For one thing, it was the second time that Bronfman, Lee, and partners had taken cash out of the company. Having paid themselves \$350 million in October from cash built up from operations, the investors have now recouped all of the \$1 billion of cash they put up for the buyout a year ago. Lee's Schoen says that while he's happy with the company's performance and the cash from the market, the investor group remains at risk. "All of our profits are still invested in the company," he says.

CLAMORING FOR BONDS

STILL, INSTITUTIONAL portfolio managers holding debt do not like to see the private equity firms getting their original stake back so quickly after buying a company. "Now they're sort of playing with other people's money," says Fridson. The fear is that the owners will then be tempted to take too many risks now that their original outlay has been returned to them. But Fridson concedes that such misgivings are not stopping institutions from clamoring to buy new bonds, even those of companies that already owe them a lot of money. The fact is, the portfolio managers have a lot of capital their clients expect them to invest in the market, so they hold their noses and buy more bonds.

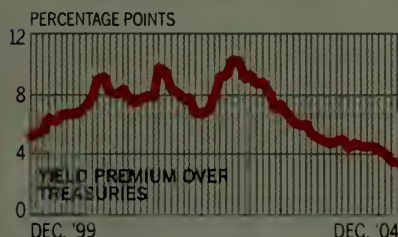
Of course, a spectacular default could bring the market to a grinding halt. In that case, the portfolio managers' clients would likely rush to pull out their investments, thus cutting off the source of funds that are being used to pay special dividends.

Events may not come to such a pass. After all, the IPO market is picking up and once again bringing buyout firms' traditional exit strategy back within reach. Investors led by Blackstone Group were looking in mid-January toward a \$1.2 billion stock offering for a cluster of entities they've assembled around the chemical giant formerly called Celanese AG, which they bought last April. Although Blackstone had already taken out \$638 million from junk sales last year, the investors were looking for an additional \$950 million payout from the IPO and some additional borrowing. If deals like that work, stock investors may save the junk-bond market from itself. ■

—By David Henry in New York

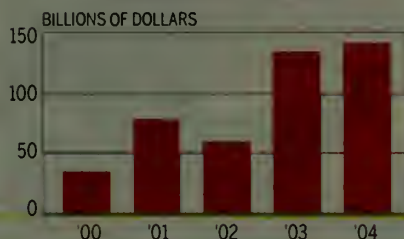
BIG PAYDAYS FOR BUYOUT FIRMS

Investors are accepting lower yields on junk bonds...



Data: JP Morgan Chase & Co.

...and buying record amounts of them...



Data: Thomson Financial

...allowing buyout firms to borrow to pay themselves big dividends

COMPANY / INDUSTRY BUYOUT FIRM	DIVIDEND (MILLIONS)
WARNER MUSIC GROUP Music Thomas H. Lee, Music Capital Partners, Bain Capital, Providence Equity Partners	\$700
CELANESE Chemicals Blackstone Group	638*
MUELLER GROUP Valves DLJ Merchant Banking Partners	506*
UNIVERSAL CITY FLA. Amusement park NBC Universal, Blackstone	450
NALCO Water treatment Blackstone, Apollo Management, Goldman Sachs Capital Partners	445
INMARSAT Satellite communications Apax Partners Worldwide, Permira Advisers	406*
VWR INTL. Scientific supplies Clayton, Dubilier & Rice	296
HERBALIFE Weight loss and nutrition Whitney & Co., Golden Gate Capital	275

* Dividends financed by multiple offerings

Data: Standard & Poor's LCD

Can the Street Make Research Pay?

In the Eliot Spitzer era, it's looking more and more like an expensive luxury

TOP WALL STREET FIRMS have a problem: They maintain huge research departments that can cost them \$500 million or more a year each. And yet they can't figure out how to get their biggest customers to pay for the stream of analyst reports they churn out. Two years after they reached a \$1.4 billion settlement with regulators to end conflicts of interest between their investment banking and research arms, big banks and brokerage firms are casting about for a new business model to turn their stock and bond research into a moneymaker—or at least make it self-supporting. “The day-to-day business of research is just going to have to change,” says Allan Rosenstein, a partner at Capco, a financial-services consulting firm in New York.

The settlement was a plus for retail investors, who now get three opinions on the stocks in their portfolios from independent analysts for free. But it turned off one of the two traditional spigots for subsidies to finance research. It banned the direct use of investment banking fees to offset research costs, aiming to end the practice of issuing glowing reports on a company to win its business.

Now, market forces are draining the second source of subsidies. Institutional investors such as pension and mutual



funds are leaning on the firms to cut their trading commissions. For years, these customers have paid a bundle in commissions, and in return they got reams of research and other perks. These days they're more interested in receiving lower commissions than research, which is now abundantly avail-

able from a crop of new companies bankrolled by the settlement with The Capital Group, which manages \$800 billion for the No. 3 mutual fund family, American Funds, slashing commissions it pays to Wall Street last year. Overall, total trading commissions paid by U.S. money managers fell 10% last year, to \$11.3 billion, according to consulting firm Greenwich Associates. Capco's Rosenstein says that 55% of that total went toward the firms' research bill.

Wall Street's research departments may soon suffer another blow. Regulators are scrutinizing the firms' practices of rebating part of their trading commissions to customers. The rebates,

“soft dollars,” are proposed to be used to “buy” research, but has come to include extras such as access to financial-information terminals and proprietary databases.

This probe forces Wall Street to break out for the first time how much of its trading commissions go to research. A Securities & Exchange Commission task force will recommend options include putting strict limits on what can be purchased with soft dollars, more disclosure to mutual-fund boards about what soft dol-

lars are used for, and a flat-out appeal to Congress to end the use of soft dollars.

Wall Street's first reaction to this series of events has been to take an axe to research departments. Research budgets at the seven biggest U.S. securities firms have fallen by more than 50% since 2000, according to research

Research and Rewards

How the game is changing:

CUTTING BACK Analysts are being let go as firms trim the number of companies and sectors they cover and eliminate routine reports that do little more than mirror earnings releases or company news. Senior analyst salaries are down 50%.

OUTSOURCING COVERAGE Banks are shipping basic data collection and financial modeling offshore to companies such as OfficeTiger of Chennai, India and contracting out some coverage to outfits such as Standard & Poor's.

BUILDING REVENUES Many firms have begun selling their research databases to institutional investors; premium subscriptions or customized reports for institutional and retail investors may also be in store.

d C. Bernstein & Co. in New York. Over the same period, firms have seen average annual pay of a senior analyst drop in half, to roughly \$750,000. "Goodletting will surely continue. I've got way too many analysts," says a top exec at a major Wall Street firm. "I hope that some just get out of business."

PLACE FOR OPINIONS

WALL STREET MUST NOW reinvent its research operations so that they pull in a fair share of revenues than the paltry \$172 million collected last year. Some firms are expected to start charging for one-on-one meetings with their top-ranked analysts. Some customers who don't guarantee a certain level of business may have to pay subscription fees to get research. For the first time, Merrill Lynch & Co. will sell access to its analysts' riches of company financials. Others are expected to follow. But so far no one has found a magic formula to staunch the drain.

Investors, meanwhile, are increasingly turning to smaller, independent sources for stock tips. In a poll by Thomson Financial last summer, 60% of money managers said research from independent firms that don't sell stocks or advise company mergers—was superior to Wall Street's. Says Joe Hill, a hedge fund manager with Imperium Capital Management: "Wall Street has solid models and good industry information, but it's a place for opinions."

A daunting task for Wall Street now is to keep cutting budgets while maintaining a quality product that will attract enough business to fund it. "As the exodus has come out of the system, the appetite for mediocrity has waned," says Bruce Browning, Merrill's head of securities research and economics. Says Merrill is now far more demanding of its analysts, expecting more creative ideas and a global perspective. To free up its top analysts for more poaching with CEOs and big money managers, Wall Street is also hiring analysts overseas. J.P. Morgan, Goldman Sachs Group, and Citicorp use analysts or support staff in India. This has been a boon to New York-based OfficeTiger, which has eight of the world's 12 largest investment banks and employs 200 researchers in India, primarily to do basic number-crunching.

The type of research Wall Street offers is changing, too. The once-automatic recommendation a company issued after an earn-

ings announcement is fast disappearing because it does little to set a research firm apart from rivals. Other firms are mulling ending coverage of whole industries, say telecom, or asset classes, such as small-cap stocks. Some big banks might contract out this coverage so they can continue to supply it to their institutional customers. Research-only outfits such as Standard & Poor's, which like *BusinessWeek* is owned by The McGraw-Hill Companies, expect to benefit, as they already cover many of the companies being dropped by Wall Street.

Pressure on Wall Street from big

money managers isn't likely to let up, either. In July, Boston's Fidelity Investments phased out some fees it paid for research and has urged the SEC to mandate better disclosure of how Wall Street charges for its reports. Fidelity wants to receive only "higher-value, customized research," says Fidelity spokesman Scott Beyerl. "We believe that investors, fund managers, and brokers would benefit if all managers did the same." That's a recommendation that might carry more weight than a buy, sell, or hold. ■

—By Mara Der Hovanesian in New York, with Amy Borrus in Washington

Stock Market

Molasses in January

A weak start—like this year's—can signal a bear market. Time to tread lightly?

THOUGH JANUARY IS often a lousy month—bad weather, post-holiday blues, abandoned resolutions—it's usually one of the best months for stocks. That's largely due to "the January effect" as folks pour yearend bonuses into the market and allocate new money to retirement plans and the like, causing the market to rally. This year, it seems like a bad joke. The Standard & Poor's 500-stock index is down 1.3% in the new year. The Dow Jones industrial average has sunk 1.4%, and the NASDAQ Composite index is down about 2%.

Market mavens aren't amused. Every January in which the S&P 500 index has fallen since 1950 has preceded a down or flat market, says Jeffrey A. Hirsch, editor of the *Stock Trader's Almanac*.

Of course, Mr. Market could play another

joke and stage a rebound in the waning days of January or in February. But that could turn out to be no more than a suckers' rally. Already, the current bull market has hung around for 2½ years, perilously close to the 2½-year average duration for bull runs, warns Richard T. McCabe, chief market analyst at Merrill Lynch & Co.

Investors have had their fun by taking profits from the market's sizable post-election runup. And what's now happening—such as a slew of earnings warnings from the likes of Home Depot and General Motors—is no laughing matter. Along with rising interest rates, a weak dollar, higher inflation, and pricey oil, earnings weakness is driving investors to tears.

A sour January certainly doesn't guarantee 2005 will be bad. But it could be a hint to be a bit of a chicken when it comes to stocks. ■

—By Marcia Vickers in New York

DOWN IN THE DUMPS



The Terminator of Public Pensions?

Schwarzenegger's tough goal: Privatizing part of the state's retirement system

IN HIS 30-YEAR ACTING CAREER, Arnold Schwarzenegger has battled sorcerers, interplanetary villains, and molten cyborgs. Now California's 57-year-old governor is taking on his toughest opponent yet: the Golden State's 3 million government workers. The state's share of their retirement costs now tops \$2 billion a year—and makes up a healthy chunk of California's \$8 billion budget deficit.

To trim that, Schwarzenegger, like George W. Bush, wants to take a page from Corporate America's pension playbook and privatize part of the state's retirement system. Under his plan, state and local government workers hired after June, 2007, would no longer get guaranteed annual pensions when they retire. Instead they would be put in privately managed, 401(k)-like accounts, to which the state would contribute an amount equaling up to 6% of their salaries. The job of managing those funds would fall to the workers, resulting in cost savings and budgeting predictability for the state, says Keith Richman, the Republican assemblyman who sponsored the plan.

BROAD APPEAL

SCHWARZENEGGER'S GAMBIT may have an audience outside the Golden State. Already, six states—Florida, Montana, North Dakota, Ohio, South Carolina, and Washington—have optional private accounts.

SCHWARZENEGGER Foes say cutting unnecessary disability payouts would save money

And legislation has been introduced in 10 more.

America's public pension systems could use some reform. The 127 largest state and local plans are \$200 billion short of the funds they need to pay beneficiaries, according to the National Association of State Retirement Administrators. That has forced some states to cut services or borrow heavily to pay pensioners.

An aging population, mediocre investment returns, and delays by cash-strapped states in making contributions are partly to blame for the shortfalls. But promises of rich benefits to workers by lawmakers and other officials have made the situation worse. In California, recent changes allow state highway patrollers to retire at age 51 with an inflation-indexed pension that could be as much as

90% of their highest annual

Still, the track record of the states that have introduced private accounts has been mixed. A study of New York's system—which has offered private accounts to some workers for decades—found that employees using the accounts chose cautious investment options and earned just 6% a year on their money, compared to 11% for the state's traditional funds managed by professionals. Nor do private accounts immediately solve the problem of rising costs: Michigan introduced private accounts for new employees in 1990, but pension costs have yet to fall because the state must still make substantial payments into the old plan.

Critics of privately managed accounts

also warn that creating a two-tiered system could hinder recruitment of new workers, who might choose jobs in the private sector for less pay and higher benefits. They argue that their larger public pension funds make them more effective managers than private firms. The California Public Employees' Retirement

System says its annual management cost is just 0.18% of assets—about one-seventh of what a typical mutual fund charges.

Perhaps just as significant, under the governor's plan, CalPERS, a long-time champion of shareholders' rights, will gradually die off along with its elected members. "I'm not against pension reform," says Alberto Torrico, a Democrat and chairman of the California Assembly's pension committee.

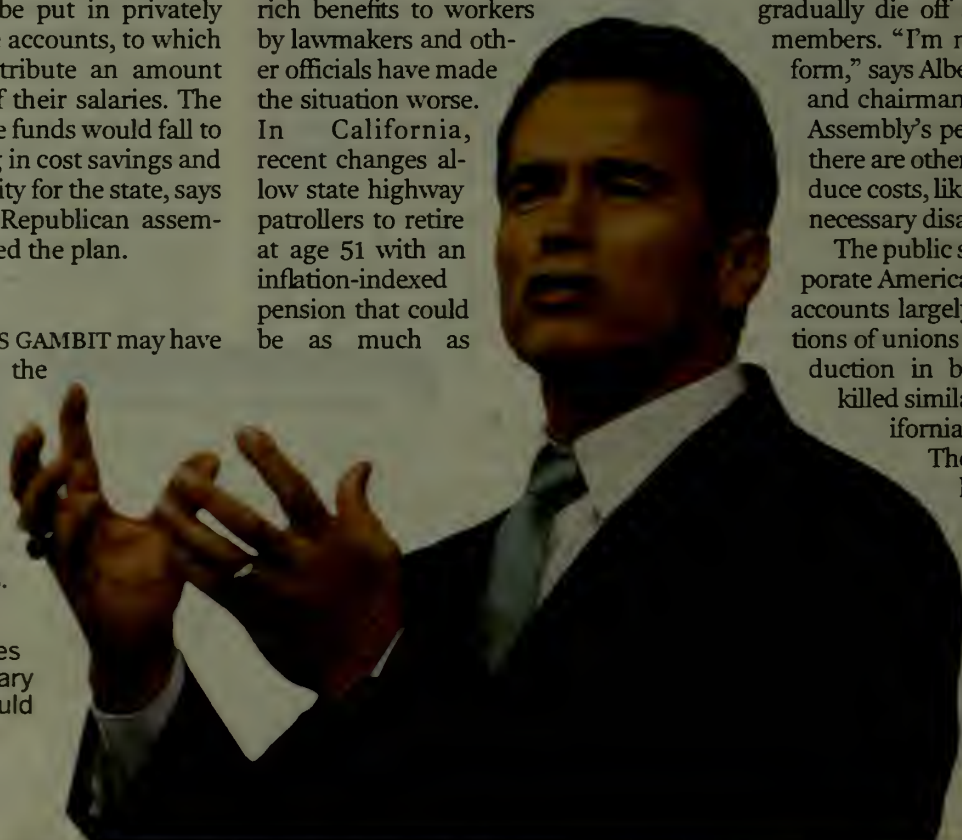
There are other things we can do to reduce costs, like cracking down on unnecessary disability payments."

The public sector is far behind Corporate America in introducing private accounts largely because of the opposition of unions that view them as a reduction in benefits. Their proposal killed similar legislation in the California Senate nine years ago.

The governor vows to push his proposal directly to the voters in a referendum. After all, a popular uprising put him in office in the first place. ■

—By Christopher Palmeri in Los Angeles and Nicholas Byrnes in New York

PENSION BLUES



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Is Your Bond Fund Reliable?

BusinessWeek's Scoreboard helps you find solid performers. **BY LEWIS BRAH**

THE RECIPE FOR A GOOD BOND FUND is simple—low fees and reliable management. Finding a low-cost one is easy. But reliable management is another story because as everybody knows, cheap isn't always good. ¶ That's where *BusinessWeek's* Mutual Fund Scoreboard can help. We rate funds from A through F on their five-year risk-adjusted returns, so not only are you able to see which funds performed well but also which ones did so with the least amount of risk. Of course, our scoreboard also has critical data on sales charges and fees plus all the pertinent performance and portfolio information. ¶ To rate the funds, we start with those having at least five-year records and measure

each one's monthly performance past 60 months. When a fund fails the "risk-free" return of U.S. T-bills, it earns negative marks, which are subtracted from its total return. We rerank the funds on these risk-adjusted results. Of 1,418 rated funds, only 14 received an A this year for their overall performance (taxable and tax-free funds rated against each other). We also ranked funds in their individual categories as international, high-yield, and convertible, comparing them only with peers. This year 96 funds received category ratings, while 50 scored A ratings in their categories and their overall performance. For an interactive ver-

Bond Fund Returns

CATEGORY	AVERAGE ANNUAL TOTAL RETURN*			
	2004	2002-2004	2000-2004	1995-2004
Emerging Markets Bond	12.5%	17.9%	15.3%	14.2%
Long (General)	6.6	8.0	8.9	8.7
Long Government	6.6	8.0	8.8	9.3
International Bond	8.8	12.0	8.0	7.6
Multisector	8.6	11.1	7.8	8.2
Intermediate (General)	4.0	5.8	7.0	7.1
Muni. Calif. Long	4.5	5.7	6.9	6.7
Muni New York Long	3.8	6.1	6.9	6.6
Intermediate Government	3.6	5.2	6.7	6.7
Muni. National Long	4.0	6.1	6.7	6.4
Muni Single-State Long	3.9	5.9	6.7	6.3
Muni. New York Interm.	3.1	5.5	6.4	6.1
Muni. High Yield	6.4	6.6	6.3	6.2

CATEGORY	AVERAGE ANNUAL TOTAL RETURN*			
	2004	2002-2004	2000-2004	1995-2004
Muni. National Interm.	3.0	5.3	5.9	5.8
Muni. Calif. Interm.	3.1	4.9	5.8	6.1
Muni. Single-State Interm.	2.9	5.0	5.8	5.8
High Yield	9.6	10.1	5.3	7.1
Short Government	2.0	3.6	5.3	5.8
Short (General)	1.7	3.4	5.1	5.8
Muni. Short	1.3	2.8	3.8	4.1
Ultrashort	1.7	2.1	3.7	4.1
Convertibles	8.5	8.0	3.6	10.1
All Taxable Funds	5.0	6.8	6.6	7.1
All Bond Funds	4.3	6.2	6.4	6.8
All Tax-Free Funds	3.5	5.5	6.3	6.8

*Appreciation plus reinvestment of dividends and capital gains before taxes

Data Standard

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for investor ed

94 | Barker: Papers to
deliver better returns

ire scoreboard, go to bwnt.businessweek.com/mutual_fund/. funds that won As for both ratings: attention, and so do funds that for category ratings. Sometimes o-rated funds are not available. Emerging Country Debt IV, for in- is the only emerging-markets und to get an A category rating, but ed to new investors. Next in line is Emerging Markets Bond, rated at's still open. Manager Mohamed n aims to minimize the downside. onitor daily and carefully calibrate osure to credit risk, interest-rate d liquidity risk," he says. Such pre- is enabled him to avoid Argentine hen that nation defaulted in 2001 weather 1998's Asian financial cri- a relatively modest losses.

PROFITS

BOND INVESTORS, though, own more diversified funds. In- n this low-yield environment, a und with a flexible investment pol- ght be just the ticket. Fidelity ic Income, for instance, typically 40% of its assets in high-yield 30% in U.S. government debt, 15% erging markets debt, and 15% in uality non-U.S. debt. Still, portfolio er Bill Eigen can adjust that mix ling on where he finds the best op- ities. In late 2002 he loaded up on eld bonds and lightened up on ries. More recently he has been profits in junk. His reward: a high ve-year annualized return, which es gains in the fund's share price. ith an expense ratio of just 0.80%, sn't have to assume steep credit o deliver an attractive 5.1% yield. hael Hasenstab of the Templeton Bond Fund can also invest any- on the planet, but he can only buy ment bonds. While interest rates ng in many countries, which is bad id prices, he's buying in countries rates are falling, such as in South Poland, and Hungary. Hasenstab vest in U.S. bonds, too, but right e's not. "There is better value out- e U.S.," he says. ing a fund for yield alone is proba- e biggest mistake you can make. evated payout may be only tempo- nd may drop when the bonds ma- ven worse, the manager might be ng in securities that could easily t. "Even bonds of companies that



Personal Business Mutual Funds

have a 50-50 chance of going bankrupt are trading near par value," says Margaret Patel, who runs the Pioneer High Yield Fund.

Manager Reid Smith of Vanguard High-Yield Tax-Exempt doesn't like chasing after yields either. But he doesn't have to, since his fund's 0.17% expense ratio is one of the lowest of all muni bond funds. "The fund doesn't have to reach for incremental yield, taking on greater risk with potentially disastrous results," says Smith.

In fact, despite the fund's name, *BusinessWeek* classifies it as an intermediate muni fund, not a high-yield muni, because, on average, its bonds are solidly investment grade. Still, the fund offers a healthy 4.6% pretax yield, which translates into 7.1% after taxes for those in the highest brackets. That's about the same as the taxable junk-bond fund, but this fund has far less credit risk.

Smith argues that the best opportunities in the bond universe are tax-exempts. He especially likes General Obligation (GO) bonds of states such as California and Massachusetts that are suffering budget problems—problems he thinks will ease as their economies get back on track. Bonds of troubled states yield more, and the chances of default are slim. "The last state GO default was in 1841," he says.

Some managers take risk control to a whole different level. Christine Jones



The fund doesn't have to reach for incremental yield, taking on greater risk.."

—Reid Smith, Vanguard High Yield Tax-Exempt Fund

Thompson of the Fidelity Spartan Municipal Income Fund has 25 credit analysts, traders, and quantitative researchers constantly poring over her \$4.6 billion portfolio. Every day she stress-tests her bonds under 12 separate hypothetical scenarios—such as rising rates, falling rates, credit deterioration—to see what impact they might have on the fund. "We may think that short-term rates will rise, and manage the portfolio accordingly," she says. "But equally important is knowing what

might happen to the fund if rates rise as quickly as expected." That analysis might prompt them to less rate-sensitive bonds. Such a move resulted in an impressive 7.6% annualized average return.

Of course, there are many different kinds of risks. Investors in the five-year American Century Target Maturity fund, which is on the A list don't have to worry much about defaults because their zero-coupon bonds are backed by the U.S. government. But such bonds are extremely sensitive to shifts in interest rates. In fact, in 2004, American Century Target Maturity 2025 Inv., which owns securities maturing in that year, fell 20.7% when rates rose in 1999, then gained 32.7% as rates dropped again. The past five years of falling rates have been a boon for the fund, but the next five might be a different story. Yet manager Jeremy Fletcher says the funds provide "predictable returns to those who hold them until their maturity dates. "Investors know they get their money back," he says.

Target maturity funds might not be for all investors, but funds that fit your investment certainly will. ■

The Biggest Bond Funds

Here's how *BusinessWeek* rates the largest bond funds

FUND	ASSETS/ BILLIONS	OVERALL RATING	CATEGORY	CATEGORY RATING	AVG. ANNUAL TOTAL RETURN*
Vanguard Total Bond Mkt. Index	\$19.0	B	Interm. (General)	B	7.2%
Vanguard GNMA	18.8	B	Interm. Government	B+	7.0
Bond Fund of America A	15.5	B	Interm. (General)	C	7.5
Vanguard Short-Term Inv. Grade	13.0	C	Short (General)	B+	5.6
Franklin Calif. Tax Free Income A	12.2	B	Muni. Calif. Long	C	6.9
PIMCO Total Return A	8.8	B	Interm. (General)	C	8.0
Dodge & Cox Income	7.6	B+	Interm. (General)	A	8.2
Vanguard High Yield Corp. Inv.	7.3	C	High Yield	B	5.7
American High Income A	7.3	C	High Yield	B	7.2
Fidelity Intermediate Bond	7.1	B	Interm. (General)	B	7.1
Vanguard Intermed. Tax Exempt	6.8	B	Muni. Natl. Interm.	B	6.0
Franklin U.S. Govt. Securities A	6.3	C	Short Government	B	6.4
Franklin Fed. Tax Free Inc. A	6.2	C	Muni. Natl. Long	C	6.6
Fidelity Investment Grade Bond	6.2	B+	Interm. (General)	B	7.6

* Vanguard Inflation Protected Securities Fund has \$6.8 billion but is not rated because it does not yet have a five-year record

** Appreciation plus reinvestment of dividends and capital gains before taxes, 2000-2004

Data: Standard & Poor's



BusinessWeek online For interviews with fund managers, see www.businessweek.com/magazine/extra.htm, and for complete details of more than 5,200 funds, go to <http://bwnt.businessweek.com/mutual>

to Use the Tables

The risk-of-loss factor is the potential for money in a fund, calculated as follows: The Treasury bill return is subtracted from the

FUND CATEGORIES General bond funds are classified long-term (CL), intermediate-term (CI), short-term (CS), and ultrashort (UB); government, long (GL), intermediate (GI), and short (GS); municipal, national long (ML), national intermediate (MI), single-state long (SL), single-state intermediate (SI), Calif. long (MC), Calif. intermediate (MF), New York long (MY), New York intermediate (MN), short-term (MS) and high-yield (MH); specialized funds, convertible (CV), high-yield (HY), international (IB), emerging markets (EB), and multisector (MU).

TELEPHONE NUMBERS See index on page 89.

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Personal Business Mutual Funds

FUND	RATING (COMPARES RISK-ADJUSTED PERFORMANCE OF EACH FUND AGAINST ALL FUNDS)	CATEGORY	RATING (RATING COMPARES FUND WITHIN CATEGORY)	SIZE ASSETS \$ MIL.	% CHG. 2003-2004	FEES SALES CHARGE (%)	EXPENSE RATIO (%)	PERFORMANCE TOTAL RETURN (%) 1YR. 3YR. 5YR.	PORTFOLIO YIELD (%) MATURITY (YEARS)	H R A
GMO INFLATION INDEX BOND III GMIIX	A	GL	B	724.7	53	No load	0.25	8.0 10.0 10.4	3.9 11.3	1
GMO INTERNATIONAL BOND III GMIIX	A	IB	A	400.2	118	No load	0.39	14.5 19.6 10.7	8.4 2.7	5
HARBOR BOND INSTL. HADBXX	B+	CI	A	1570.5	3	No load	0.58	5.5 7.1 8.3	2.8 6.0	2
ING INTERMEDIATE BOND A IIBAX	B+	CI	A	421.9	106	4.75	1.10†	4.3 6.7 9.3	3.0 6.0	2
LOOMIS SAYLES BOND INSTL. LSBXX	A	MU	A	2603.4	38	No load	0.75	11.3 17.7 11.8	6.9	5
LOOMIS SAYLES GLOBAL BOND RETAIL LSLGX	A	IB	B+	497.2	540	No load	1.04†	9.5 16.8 10.6	2.7 5.9	5
LOOMIS SAYLES INVESTMENT GRADE BOND Y LSIIX	A	MU	A	13.7	37	No load	0.55	9.9 13.2 11.3	6.8 8.6	2
LOOMIS SAYLES STRATEGIC INCOME A NEFZX	A	MU	B+	414.4	149	4.50*	1.23†	12.9 20.5 12.0	5.5 12.3	5
LOOMIS SAYLES U.S. GOVT. SEC. INSTL. LSGSX	B+	GI	A	7.2	-17	No load	0.50	4.4 7.1 8.6	4.0 9.3	1
MAINSTAY GLOBAL HIGH INCOME A MGHAX (a)	A	EB	C-	45.8	29	4.50	1.63†	12.9 18.2 15.4	6.3 13.0	3
MANAGERS BOND MGFIX	A	CI	A	244.8	46	0.00*	0.99	5.1 8.9 9.2	4.2 8.2	3
MANAGERS FIXED INCOME Y MFDYX (b)	B+	CI	A	24.0	0	No load	0.60	6.0 7.6 8.6	5.2 7.6	2
MANAGERS INTERM. DURATION U.S. GOVT. MGIDX	B	GS	A	165.2	74	No load	0.88	4.0 5.3 6.7	2.3 25.4	3
MERRILL LYNCH WORLD INCOME I MAWIX	A	IB	B+	47.9	-2	4.00	1.10	17.1 15.8 10.5	5.9 7.5	5
MFS EMERGING MARKETS DEBT A MEDAX	A	EB	B+	35.5	135	4.75*	1.41†	13.5 18.8 18.8	5.7 13.7	1
JPMORGAN FLEMING EMERGING MKTS. DEBT SEL. JEMDX	A	EB	C	35.3	-44	No load	1.26	14.3 18.2 14.8	6.8 11.3	1
MORGAN STANLEY INSTL. EMRG. MKTS. DEBT A MSIEIX	A	EB	C-	70.6	33	0.00*	1.16	10.1 16.3 14.4	6.7 13.1	1
MORGAN STANLEY INSTL. INTL. FIXED-INCOME MPIFX	A	IB	B+	169.7	39	No load	0.56	11.7 18.0 9.8	5.9 6.2	5
MORGAN STANLEY INSTL. INTERM. DURATION MAIDX	B	CS	A	7.6	-68	No load	0.53	3.2 5.0 6.8	3.7 4.2	4
NEUBERGER BERMAN HIGH INCOME BOND INV. NBHIX	B+	HY	A	822.2	49	No load	0.90	7.8 8.7 8.0	6.0 5.9	5
OPPENHEIMER INTERNATIONAL BOND A OIBAX	A	IB	A	1420.0	183	4.75	1.13†	15.6 20.7 13.9	5.4 4.6	4
PAYDEN EMERGING MARKETS BOND R PYEMX	A	EB	D	29.9	-46	0.00*	0.86	13.1 13.7 13.5	5.8 14.6	1
PHOENIX-GOODWIN EMRG. MKTS. BD. B PEMBX	A	EB	F	26.8	-40	0.00**	2.24†	7.9 16.2 10.5	6.3 NA	5
PHOENIX-GOODWIN MULTI-SECTOR S-T BD. A NARAX	B	CS	A	393.3	68	2.25	1.08†	4.8 7.1 7.3	4.4 NA	4
PIMCO EMERGING MARKETS BOND A PAEMX	A	EB	B+	239.3	22	3.75*	1.25†	11.8 18.4 19.3	3.8 11.1	1
PIMCO LONG TERM U.S. GOVERNMENT A PFGAX	A	GL	C	128.7	-10	4.50*	0.91†	6.8 9.3 10.5	2.7 20.4	1
PIMCO REAL RETURN BOND A PRTNX	A	GI	A	2951.8	69	3.00	0.90†	8.7 11.0 10.9	3.3 11.1	1
PIMCO TOTAL RETURN MORTGAGE D PTMDX	B+	GS	A	101.1	-2	No load	0.90†	4.5 5.8 7.7	2.6 4.2	2
PIONEER HIGH YIELD A TAHYX	A	HY	A	3578.6	5	4.50	1.06†	6.7 11.1 12.6	5.9 6.8	1
PIONEER STRATEGIC INCOME A PSRAX	A	MU	B+	276.2	93	4.50	1.08†	10.5 13.5 10.5	5.5 6.6	5
T. ROWE PRICE CORPORATE INCOME PRPIX	B+	CI	A	199.3	99	No load	0.75	7.1 8.1 8.4	4.9 10.7	4
T. ROWE PRICE EMERGING MARKETS BOND PREMXX	A	EB	C	265.6	9	0.00*	1.10	14.8 16.6 14.8	5.9 11.2	1
REGIONS MORGAN KEEGAN SEL. HI. INC. A MKHIX	A	HY	A	466.3	44	2.50	1.11†	16.1 14.1 15.4	10.4 7.2	1
REGIONS MORGAN KEEGAN SEL. INTERM. A MKIBX	B+	CI	A	137.4	54	2.00	0.81†	7.0 7.2 9.1	7.5 6.5	1
SB CONVERTIBLE SMITH BARNEY A SCRAX	B+	CV	A	44.9	12	5.00	1.18†	7.0 10.7 9.1	2.5 NA	4
SCUDDER EMERGING MARKETS INCOME S SCEMX	A	EB	C	144.9	3	No load	1.63†	14.0 19.1 15.5	4.8 11.3	3
SCUDDER PRESERV. PLUS INCOME INV. DBPIX	C	UB	A	796.0	-48	0.00*	1.00†	6.5 5.2 5.7	3.8 2.5	5
SCUDDER PRESERV. PLUS INVEST. BTPSX	C-	UB	A	137.7	37	0.00*	0.65	3.8 4.6 5.0	3.0 2.6	5
SEI EMERGING MARKETS DEBT A SITEX	A	EB	B	778.9	35	No load	1.35	14.5 19.5 16.8	5.8 16.3	1
SENTINEL GOVERNMENT SECURITIES A SEGSX	B	GS	A	104.7	2	4.00	0.95†	4.7 6.0 7.5	4.1 3.2	1
TCW GALILEO EMERGING MARKETS INCOME I TGEIX	A	EB	B	53.5	12	0.00*	1.07	12.9 18.1 16.2	5.7 3.6	3
TCW GALILEO TOTAL RETURN BOND I TGLMX	B+	GI	A	171.0	18	No load	0.51	5.2 6.4 8.4	4.7 4.3	1
TEMPLETON GLOBAL BOND A TPINX	A	IB	A	721.9	70	4.25	1.13†	14.6 18.6 12.3	4.4 NA	5
THOMPSON PLUMB BOND THOPX	B	CS	A	29.7	-29	No load	0.80	3.1 6.1 7.3	5.4 3.0	4
VANGUARD INTERM. TERM BD. INDEX VBIIIX	B+	CI	A	3392.5	26	No load	0.20	5.2 7.2 8.7	4.7 7.6	1
VANGUARD INTERM. TERM TRSY. INV VFITX	B+	GI	A	2155.1	-7	No load	0.26	3.4 6.5 8.2	4.5 6.2	1
VANGUARD LONG TERM BOND INDEX VBLTX	A	CL	B	1240.0	34	No load	0.20	8.4 9.4 10.5	5.2 20.0	1
VANGUARD LONG TERM INVEST. GRADE VVWSX (c)	A	CL	B	4067.5	7	No load	0.28	8.9 9.4 9.9	5.5 21.0	2
VANGUARD LONG TERM TREASURY INV. VUSTX	A	GL	C	1416.0	-5	No load	0.26	7.1 8.7 9.9	5.0 17.0	1
WASATCH HOISINGTON U.S. TREASURY WHOSX	A	GL	C	47.5	-22	0.00*	0.75	10.2 9.3 10.4	4.5 20.1	1
WESTCORE FLEXIBLE INCOME WTLTX	A	HY	A	110.8	226	0.00*	0.85	10.4 12.2 10.7	6.6 NA	2
WESTCORE PLUS BOND WTIBX	B+	CI	A	153.0	169	0.00*	0.55	6.4 8.4 8.4	5.4 NA	3
WESTERN ASSET CORE BOND I WATFX	B+	CI	A	2818.5	47	No load	0.49	5.3 7.3 8.9	3.3 6.5	1
WESTERN ASSET CORE PLUS BOND I WACPX	A	CI	A	4181.2	59	No load	0.45	7.5 8.6 9.5	3.2 7.3	2
WESTERN ASSET NON U.S. OPPORT. BOND I WAFX	A	IB	B+	109.7	92	No load	0.55	10.0 10.7 9.4	2.7 8.7	5

TAX-FREE FUNDS

AMER. CENTURY CALIF. HIGH YIELD MUNICIPAL INV. BCHYX	A	MC	A	336.0	-1	No load	0.53	6.7 7.2 7.8	5.1 21.0	1
AMER. CENTURY CALIF. L-T TAX FREE INV. BCLTX	A	MC	B+	465.1	-7	No load	0.50	4.1 5.7 7.2	4.3 14.0	1
AMER. CENTURY HIGH YIELD MUNI. INV. ABHYX	A	MH	B+	59.4	14	No load	0.64	6.3 7.5 7.2	4.8 17.0	4
COLUMBIA PA. INTERM. MUNI. BOND Z GTPAX	B+	SI	A	20.8	-18	No load	1.23	2.4 5.2 6.6	3.1 8.1	1
CONSULTING GRP. CAP. MKTS. MUNI. BD TMUUX	A	ML	B+	34.8	23	No load	0.89	4.1 6.3 7.2	3.8 NA	1
DREYFUS PREMIER CALIF. TAX EXEMPT BD. Z DRACX (d)	A	MC	B+	1200.6	12	0.00*	0.70†	4.7 5.9 7.2	3.8 17.8	1
DREYFUS PREMIER SELECT MUNI. BOND Z DRMBX	A	ML	B+	208.8	-11	No load	0.45†	4.6 6.3 7.2	4.3 15.1	1
DUPREE ALA. TAX FREE INCOME DUALX	A	SI	A	6.5	29	No load	0.40	5.0 7.0 8.5	4.2 7.0	1
DUPREE MISS. TAX FREE INCOME DUMSX	A	SI	A	4.0	39	No load	0.40	4.8 7.2 8.2	4.1 8.7	1
EATON VANCE MUNICIPAL BOND A ETMBX	A	ML	B+	112.5	11	4.75	0.89†	4.6 7.1 8.2	5.4 20.9	1
EATON VANCE NATL. MUNICIPALS A EANAX	A	ML	B+	1790.7	607	4.75	0.78†	6.6 8.9 8.4	5.6 22.2	2
FIDELITY SPARTAN ARIZ. MUNI. INC. FSAZX	B+	SL	A	82.6	11	0.00*	0.53	3.7 6.3 6.9	3.7 13.5	2
FIDELITY SPARTAN CALIF. MUNI. INC. FCTFX	A	MC	B+	1452.7	-5	0.00*	0.48	4.9 6.1 7.1	4.2 14.3	1
FIDELITY SPARTAN CONN. MUNI. INC. FICNX	B+	SL	A	426.3	-3	0.00*	0.49	3.5 6.1 6.9	4.0 12.4	2
FIDELITY SPARTAN FLA. MUNI. INC. FFLIX	B+	SL	A	504.4	-8	0.00*	0.48	4.5 6.2 6.8	4.0 13.4	3

*Includes redemption fee. **Includes deferred sales charge. †12(b)-1 plan in effect. ‡Closed to new investors. NA=Not available.

(a) Formerly MainStay Funds Global High Yield A. (b) Formerly Consecro Srs. Tr. Fixed Income Y. (c) Formerly Vanguard Long Term Corp. (d) Formerly Dreyfus California Tax Exempt Bond Fund.

Data: Standard &

	RATING (COMPARES RISK-ADJUSTED PERFORMANCE OF EACH FUND AGAINST ALL FUNDS)	CATEGORY (RATING COMPARES FUND WITHIN CATEGORY)	RATING	SIZE ASSETS \$ MIL.	% CHG. 2003-2004	FEES SALES CHARGE (%)	EXPENSE RATIO (%)	PERFORMANCE TOTAL RETURN (%)			PORTFOLIO		HISTORY RESULTS VS. ALL FUNDS
								1 YR.	3 YR.	5 YR.	YIELD (%)	MATURITY (YEARS)	
Y SPARTAN INTERM. MUNI. INC. FLTMX	B+	MI	A	1787.5	0	0.00*	0.43	3.7	6.0	6.5	3.9	8.4	332223
Y SPARTAN MASS. MUNI. INC. FDMMX	A	SL	A	1737.2	-5	0.00*	1.15	4.5	6.5	7.1	4.3	15.7	231223
Y SPARTAN MICH. MUNI. INC. FMHTX	A	SL	A	554.1	0	0.00*	0.49	3.9	6.5	7.1	4.0	12.3	231223
Y SPARTAN MUNICIPAL INCOME FHIGX	A	ML	A	4591.1	-4	0.00*	0.47	4.7	6.9	7.6	4.3	16.1	131222
Y SPARTAN N.Y. MUNI. INC. FTFMX	A	MY	B+	1362.5	-4	0.00*	0.48	4.4	6.9	7.6	4.0	15.2	140222
Y SPARTAN OHIO MUNI. INC. FOHFX	A	SL	A	417.7	-2	0.00*	0.50	4.4	6.5	7.2	4.1	14.3	232222
Y SPARTAN PENN. MUNI. INC. FPXTX	B+	SI	A	291.2	0	0.00*	0.50	4.3	6.1	6.8	4.1	13.0	242222
Y SPARTAN SHORT INTERM. MUNI. INC. FSTFX	D	MS	A	1850.6	2	0.00*	0.47	1.8	3.7	4.6	2.6	3.3	524445
AMERICAN CALIF. TAX FREE Y FYNTX	A	ML	B+	416.5	-8	No load	0.70	4.5	6.8	7.3	4.5	15.9	141222
INSIGHT INTERM. T-E BOND N HIXAX	B+	MI	A	8.3	-31	No load	0.70	2.8	5.5	6.5	4.0	8.2	232224
INSIGHT TAX EXEMPT BOND N HXBAX	A	ML	A	23.9	-5	No load	0.76	3.2	6.6	7.9	4.2	12.9	121224
NETT GA. TAX FREE INCOME A LAGAX	B+	SL	A	89.5	4	3.25	0.68†	4.7	6.0	7.6	3.9	NA	122222
LYNCH MUNI. BOND NATL. B MBNLX	A	ML	B	199.0	-28	0.00**	1.35†	4.8	6.3	6.9	4.4	17.9	242222
STANLEY INSTL. MUNICIPAL MPMFX	B+	MS	A	387.2	8	No load	0.50	2.9	5.5	6.8	2.7	5.9	222224
CALIF. TAX EXEMPT NCATX	A	MC	B+	100.3	-11	No load	0.85	4.2	6.3	7.3	4.1	16.4	141222
ERN INTERMEDIATE TAX EXEMPT NOITX	B+	MI	A	588.1	-8	No load	0.85	3.2	5.6	6.5	3.2	10.3	412224
ERN TAX EXEMPT NOTEX	A	ML	B+	489.9	-8	No load	0.85	4.1	6.4	7.2	4.1	14.6	131223
HIGH YIELD MUNI. BOND A NHMAX	A	MH	A	496.3	190	4.20	0.95†	11.4	9.8	9.6	5.5	20.7	141221
ROUP TAX FREE BOND I PRBIX	B+	MI	A	437.2	-10	No load	0.59	4.0	6.1	6.9	4.4	6.9	242223
HEIMER PENN. MUNICIPAL A OPATX	A	SL	A	263.7	28	4.75	0.86†	7.1	9.3	8.3	5.4	10.8	422221
HEIMER ROCHESTER NATIONAL MUNI. A ORNAX	A	MH	B+	1056.3	155	4.75	0.80†	10.6	10.5	9.5	6.8	17.9	232221
CALIF. TAX FREE INCOME INV. CATIX (e)	A	MC	A	84.3	-2	No load	0.63	5.5	6.2	8.2	4.3	NA	142222
MUNICIPAL BOND INV. PBIMX (f)	A	ML	A	508.6	-9	No load	0.61	5.5	7.3	8.1	4.3	NA	131222
PRICE SUMMIT MUNI. INCOME PRINX	A	ML	B+	102.5	10	No load	0.50	5.2	6.8	7.5	4.4	14.4	232222
PRICE GA. TAX FREE BOND GTFBX	B+	SL	A	92.8	6	No load	0.65	4.0	6.0	6.8	4.1	13.7	232223
PRICE TAX FREE INCOME PRTAX	A	ML	B+	1441.4	-3	No load	0.54	4.3	6.2	7.0	4.3	14.2	142222
PRICE MD. TAX FREE BOND MDXBX	A	SL	A	1277.9	-3	No load	0.48	4.0	6.1	6.9	4.8	14.2	232223
PRICE N.J. TAX FREE BOND NJTFX	A	SL	A	158.2	3	No load	0.58	4.2	6.3	7.0	4.3	13.5	232222
PRICE N.Y. TAX FREE BOND PRNYX	A	MN	B+	235.0	1	No load	0.55	3.9	6.1	7.0	4.1	13.7	142223
PRICE VA. TAX FREE BOND PRVAX	A	SL	A	425.6	4	No load	0.52	4.0	6.2	7.1	4.2	13.6	131223
CALIF. LONG TERM TAX FREE BOND SWCAX	A	MC	A	183.5	-4	No load	0.61	5.0	5.9	7.5	4.2	16.8	132222
LONG TERM TAX FREE BOND SWNTX	A	ML	A	85.2	7	No load	0.65	4.0	6.8	7.9	3.9	13.0	151223
ER MASS. TAX FREE S SCMAX	B+	SL	A	452.7	-8	No load	0.74†	3.2	6.4	6.8	4.7	9.2	241224
SSIC VA. MUNI. BOND T CVMTX	B+	SI	A	47.2	2	0.00*	0.77	3.4	5.6	6.5	3.5	7.6	242223
FLORIDA TAX FREE INCOME ULFTX	A	SL	A	257.0	10	No load	0.64	4.7	6.7	7.5	4.2	15.0	132222
AX EXEMPT CALIF. BOND USCXB	A	MF	A	661.3	-1	No load	0.58	4.8	6.1	7.1	4.3	16.6	152222
AX EXEMPT LONG TERM USTEX	A	ML	A	2246.0	1	No load	0.56	5.6	7.4	7.7	4.5	14.7	141221
AX EXEMPT N.Y. BOND USNYX	A	MY	A	127.3	1	No load	0.69	4.7	6.6	7.7	4.4	15.7	142222
AX EXEMPT VA. BOND USVAX	A	SL	A	504.2	1	No load	0.61	4.5	6.4	7.3	4.3	15.3	142222
ARD CALIF. LONG TERM TAX-EXEMPT INV. VCITX	A	MF	A	1273.0	-1	No load	0.17	4.2	6.2	7.3	4.6	7.6	152222
ARD FLA. LONG TERM TAX-EXEMPT VFLTIX	A	SI	A	679.2	-5	No load	0.17	4.1	6.8	7.6	4.3	8.3	141223
ARD HIGH YIELD TAX EXEMPT VWAHX	A	MI	A	2718.4	3	No load	0.17	5.0	6.2	6.9	4.6	7.8	232222
ARD INSURED LONG TERM TAX EXEMPT VILPX	A	MI	A	1854.4	-4	No load	0.17	3.9	6.5	7.5	4.5	8.2	141223
ARD LONG TERM TAX EXEMPT VWLTX	A	ML	B+	1106.2	-3	No load	0.17	4.1	6.5	7.4	4.5	8.0	131223
ARD MASS. TAX EXEMPT VMATX	A	SI	A	449.9	9	No load	0.16	4.1	6.1	7.2	4.0	7.3	142223
ARD N.J. LONG TERM TAX EXEMPT INV. VNJTIX	A	SI	A	895.8	-3	No load	0.17	4.0	6.3	7.2	4.5	7.9	141223
ARD N.Y. LONG TERM TAX EXEMPT INV. VNYTX	A	MN	A	1302.5	-1	No load	0.17	4.0	6.7	7.5	4.2	7.8	141223
ARD OHIO LONG TERM TAX EXEMPT VOHIX	A	SI	A	499.0	1	No load	0.15	4.1	6.7	7.5	4.4	7.1	141223
ARD PENN. LONG TERM TAX-EXEMPT INV. VPAIX	A	SI	A	1443.9	-5	No load	0.17	3.9	6.5	7.4	4.5	7.0	131223
FARGO MINN. TAX FREE I NWMIX	A	SL	A	134.4	-18	No load	0.60	4.1	6.1	7.2	4.2	NA	132223
FARGO NATIONAL TAX FREE I NTFTX	A	ML	B+	186.7	-16	No load	0.60	4.8	5.9	7.1	4.5	NA	132222

*Includes redemption fee. **Includes deferred sales charge. †12(b)-1 plan in effect. ‡Closed to new investors. NA=Not available.

Data: Standard & Poor's

Formerly SAFECO California Tax Free Income Inv. (f) Formerly SAFECO Municipal Bond Fund Inv.

phone numbers

BERNSTEIN

672

AN CENTURY

2021

DS

759

OCK FUNDS

762

F FUNDS

8332

S FUNDS

9943

IA FUNDS

6611

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LOOMIS SAYLES FUNDS
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LORD ABBETT FUNDS
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MAINSTAY FUNDS
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MANAGERS FUNDS
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MERRILL LYNCH FUNDS
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MFS FUNDS
800 225-2606

JPMORGAN FUNDS
800 348-4782

MORGAN STANLEY INSTL.
FUNDS
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NEUBERGER BERMAN
FUNDS
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NORTHERN FUNDS
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NUVEEN FUNDS
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800 572-9336

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SELECT FUNDS
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Between You, the Doctor, and the PC

More physicians and hospitals are putting their medical records online. **BY CAROL MARIE CROPPER**

DR. DAVID BOWER, chief of staff at the Atlanta Veterans Administration Medical Center, got a call at home one night about an elderly man in intensive care. The patient had shortness of breath, and the medical resident on site wanted help with a diagnosis. Without returning to the hospital, as might once have been required, Bower went to his home computer, logged on to the hospital's intranet, and looked at the man's chest X-ray. His verdict: pulmonary edema, a potentially fatal buildup of fluid in the lungs. The patient was given a diuretic, and his condition improved.

Such stories are becoming more frequent as hospitals and physicians shift from paper to computerized health records. Right now, no more than 15% of U.S. hospitals and doctors use such systems, according to Dr. David Bates, chief of internal medicine at Brigham & Women's Hospital in Boston and an expert on electronic records in patient care. But with the government and health-care leaders pushing for expansion, Bates predicts 70% to 80% of all hospitals and 50% to 60% of physicians will be onboard in five years.

More than 500 groups answered a call from the government for suggestions on how to create a national health information network by 2014, a goal of President Bush. One of those responding by the Jan. 18 deadline was a consortium of 13 prominent health and information technology groups

organized by the Markle Foundation in New York. It suggested linking medical networks via the Internet and called for the creation of an entity to devise standards and policies for this new medical Net.

HOW PRIVATE?

A MOVE TO ELECTRONIC records could make a patient's medical files accessible anywhere in the world. Proponents point to reduced costs and increased patient safety. Meanwhile, privacy advocates raise questions about security. Of major concern is that there not be a central, na-

tional repository of patient info but rather a network of records maintained by individual providers and systems. "I don't think a national base would fly in this country," says Givens, director of the Privacy Clearinghouse, a nonprofit that focuses on such issues. She says such a system would be vulnerable to insider attacks and could become a target for hackers.

The VA system for which Bower is a leader in information technology is a leader in information technology with its doctors ordering drugs, laboratory tests, and X-rays by computer, entering their notes into terminals at workstations and in physician offices. All parties have access to each other's information, but their system does not provide access to records in private hospitals.

Meanwhile, at Brigham & Women's, nurses carry mini laptops as they move through the ward to dispense pills. They take handheld bar-code scanners, similar to the devices used at department stores. With the laptop, they can look up a patient's record, check the drugs the patient is to receive, then hold the scanner over bar codes printed on medication packages and the patient's wristband to make sure they match.

For patients, the new technology means their medical information is available almost instantly over an Internet or intranet system to doctors, nurses,

**Say aah.
High tech
can cut
mistakes,
but is info
secure?**



health-care workers. No more
g X-rays or charts from one of
the next as you visit a specialist
ch physicians. It could also spell
l to some of the endless ques-
ires filled out before initial doc-
its. Doctors will no longer have
o the hospital or their office to
ne latest lab results or X-rays
the patient waits for treatment.
ere are no paper files to get lost
a stack of other records.

LE AT LAST

RGUMENTS IN FAVOR of elec-
records are persuasive. Serious
ation errors fell 55% when orders
yped into a computer rather than
ritten by doctors, Bates reported
998 issue of the *Journal of the
an Medical Assn.*, as problems
g the handwriting and confusion
available dosages were eliminated.
computers can also cut costs by
g a physician ordering a test that
already been done. Software can
st less expensive drug options and
interactions and allergies. By pre-
g errors, it can eliminate costs re-
to remedial treatment or even
Dr. David Brailer, who worked at
cal technology think-tank before
named the government's new
information technology coordi-
in May, estimates potential sav-
\$140 billion a year.

ents concerned about privacy will
o ask their doctor if sensitive ma-
such as psychiatric records is
ole in their electronic record and
safeguards exist to limit access.
what access do insurers and other
medical entities have? Be aware that
ts have a right under federal law
w who has read their file. If you're
ed, ask if you can opt out of the
h or have some information ex-
l. Also, ask if your information
e shared with other medical enti-
thout your authorization.

porters of electronic records ar-
ere is actually more security—giv-
passwords and audit trails—with
onic records than with paper
s. But they admit the potential to
e a large number of files is greater.
vacy advocates will be watching as
dustry grapples with such issues.
remains to be seen how fast small
s' offices will spend the \$10,000
0,000 to shift to electronic records.
ooner or later, expect to see a bar-
canner at your wrist or a comput-
ghing up your medical files. ■

THE ACURA RL
Just \$49,470



Acura's Surprise Showstopper

The new RL looks good, drives like a dream, and brims with techno-goodies. **BY LARRY ARMSTRONG**

ACURA HASN'T SET any standards in the luxury car market for years, but its 2005 RL is bound to change that. The new flagship of Honda's upscale line looks better, handles better, and is better appointed than its predecessor. But where it really wallops the competition is in its sophisticated technology.

The price: \$49,470, fully loaded. (No factory options are available.) That makes it a bargain compared with such competitors as the Audi A6, Mercedes E Class, or BMW 5 Series. The only option I ever wished for during the week I tested it in Los Angeles was a V-8 engine; the 300-horsepower V-6 had plenty of power but not enough of the oomph that's so thrilling when you floor it.



WHERE TO? The navigation system heeds your voice

the power between the left and right rear wheels. Around corners, the system can spin the outside rear wheel faster, reducing the feeling that the car's not yet headed to where you're pointing it. Another touch: The headlights turn with the steering wheel, lighting your way around corners.

Inside, the RL has everything you expect in a luxury car, including real wood trim that swoops around from the dash to the doors. It has the full complement of safety gear and it's only the third car ever to get the highest possible ratings in government rollover and crash tests.

The interior has had a high-tech makeover as well. There's a Bose DVD-audio system that delivers surround sound to every seat, a Bluetooth link with microphone and speakers so you can use your cell phone without taking it out of your pocket, and a navigation system that recognizes more than 500 voice commands—and all U.S. cities and street names. You enter a destination, for example, by saying: "Two-Oh-One Main Street."

The navigation system is also the first in the U.S. to display traffic information from XM Satellite Radio to warn you of slow or stalled traffic on highways in 20 metro areas. One quibble: If you spot congestion ahead, you have to tell the system to find a new route. It should do it automatically. Then again, this Acura RL does everything else but drive itself. ■

EDITED BY TODDI GUTNER

FITNESS

READY FOR A SNOW-SHOVEL WORKOUT?



FORGET making your way to the gym on wintry days. You can get a great workout shoveling snow—if you do it correctly. The trick is to bend your knees and not twist your back,

which can lead to injuries, says Gregg Boughton, spokesman for the **National Athletic Trainers' Assn.** and a certified trainer in Laramie, Wyo. So when you shovel, face the pile squarely, thrust the shovel forward using your arms and legs, and turn your whole body to deposit your load. Take breaks every 10 scoops and roll your head and shoulders as well as stretch your calves and thighs. If you get tired and sore before the sidewalk is clear, call the kid next door to finish up.

—Kate Murphy

TIME OFF

KENTUCKY'S OTHER TRACK

LOUISVILLE MAY HAVE Churchill Downs and its Kentucky Derby, but Lexington has the more picturesque track: **Keeneland**. General admission is \$3 for its spring meet, which runs from Apr. 8-29. But beginning Feb. 1, you can reserve grandstand seats for \$6 to \$15 at keeneland.com. Call 800 456-3412 or e-mail tickets@keeneland.com after Feb. 28, and you might snare an unused owner's box.

—Carol Marie Cropper



LU	TXN	BA	PFE	C
3.51	22.47	51.41	25.17	47
SUNW	AMAT	EBAV		
.08	4.19	16.57	106.29	

INVESTING

Teaching the ABCs

REMEMBER THE \$80 MILLION Wall Street was ordered to set aside for investor education when the major firms settled conflict-of-interest charges in April, 2003. *BusinessWeek* has learned how the two nonprofit organizations receiving the money are planning to spend it.

The most high-profile initiative will be a 13-part television series called *Money*. Funded with part of the \$27.5 million received by the Washington-based **Investor Protection Trust (IPT)**, the series will premiere on Apr. 24 on Philadelphia's *WHYY*, then air on at least 58 other PBS stations. Each half-hour program focuses on real people talking about their experiences. In one episode, a retired teacher explains she amassed a million-dollar portfolio. Another woman tells how she fell for an investment scam. IPT President Don Blandin says many stations plan to follow with workshops and call-ins to experts. The settlement also requires IPT to award grants to all 50 states. So far it has funded projects in Arizona, Florida, and Pennsylvania. In Pennsylvania, the money will be used to train teachers to educate youngsters about personal finance.

The newly created **Foundation for Investors' Education**, in New York, has not finalized plans for its \$52.5 million. But Executive Director George Daly says it will like to help investors make informed decisions about their retirement plans at critical moments, such as when someone is rolling a 401(k) into an individual retirement account because of a job change or retirement. Daly says research shows that general investor-education programs are not effective.

—Ellen H.

AGING

Cost is often the most important factor in deciding what kind of living arrangement you will have as you enter your senior years. A recent study by the **MetLife Mature Market Institute** shows the wide price discrepancies in some major metropolitan areas.

—Ellen H.

	ASSISTED LIVING (PER MONTH)	NURSING HOME* (PER DAY)	HOME HEALTH AID (PER HOUR)
2004 national average	\$2,524	\$192	\$18
High**	3,718/Silver Spring, Md.	331/Stamford, Conn.	21/Minneapolis-St. Paul
Low**	1,340/Miami	136/Chicago	15/New York and N.J.

*Private Room **Costs do not necessarily represent highest and lowest national averages

Data: MetLife Mature Market Institute



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Mark Mallon

Chief Investment Officer



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Investment return and principal value will fluctuate, and redemption value may be more or less than original cost. In the case of a fund with more than one share class, the Morningstar Rating considered is for the share class with the longest history. American Century Investment Services, Inc., distributor.

American Century Investments, experience matters. So it should come as no surprise that the investment professionals who oversee our five distinct investment lines have an average of over 20 years of investment-management experience. They've successfully lived through the ups and downs of the market, they know the importance of staying focused. They know it's the best way to achieve long-term performance. So, does experience really matter? It does if you care about results.



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Based on funds with at least a 3-year history, Morningstar calculates a Morningstar Rating based on a Morningstar Risk-Adjusted Return measure that accounts for variations in a fund's monthly performance and the effects of sales charges, loads and redemption fees), placing more emphasis on downward variations and rewarding consistent performance. The top 10% of funds in each category receive 5 stars, the next 22.5% receive 4 stars, the next 35% receive 3 stars, the next 22.5% receive 2 stars and the bottom 10% receive 1 star. (Each share class is counted as a fraction of one fund within this category and rated separately, which may cause slight variations in the distribution percentages.) © 2004 American Century Services Corporation



BY ROBERT BARKER

These Papers Could Really Deliver

The latest headlines from newspaper companies might make investors cringe. Not just reports of weak gains in ad sales but also of higher newsprint costs and, worse yet, frauds in circulation. Even as 7 of 10 companies in the Standard & Poor's 500-stock index rose in the past year, all five of the list's press stocks sank.

To me, that spells opportunity. It's not that the industry's challenges, including online rivals, are suddenly going to evaporate. But after checking their current positions and prospects, such stalwarts as Gannett (a negative 7.2% return in 2004), Knight-Ridder (off 11.8%), and Tribune (off 17.5%) strike me as poised to deliver better days to investors.

My reasons start with the balance sheets. Gannett, for example, ended 2004 with some \$4.9 billion in long-term debt—a manageable 38% of total capital, down from more than 50% in 2000. Operating profit covers interest expense 16 times over. These companies are also repositories of hidden values: In 1981, Tribune paid \$20.5 million for the Chicago Cubs and its prime Wrigley Field real estate. Today the team might fetch 20 times more, given that Major League Baseball aims to sell its failed Montreal franchise, soon to reappear as the Washington Nationals, for an estimated \$300 million, no real estate included. On Knight-Ridder's list of assets is some long-held land in Miami that had been used as a parking lot. It's now up for sale, and the company expects to see a \$150 million gain.

TO WATCH THESE STOCKS' recent performance, you might expect that the companies had been losing money. Not so. All are set to report higher profits in late January and look forward to more gains this year. Their cash flows also remain so healthy that directors have the happy problem of deciding how much to devote to paying off debt, buying back shares, or raising dividends. In the past year, each of the companies hiked payouts by 7.8% or more (table). One reason for their strong free cash flows is their discipline in capital expenditures. Gannett's 2005 capital budget is level with last year's, while Tribune expects only a slight rise. Knight-Ridder sees its capital spending actually declining by 22%.

The knock on the stocks has been their tepid expectations for growth—only 5% to 7%. That said, the surprise would probably be on the upside if the economy, particularly hiring, picks up steam. Through their classified listings—both in print and on the Net, where Tribune collects 16% of its



Front Page News

COMPANY/SYMBOL	RECENT PRICE*	ENTERPRISE VALUE-EBITDA** RATIO	DIVIDEND YIELD	LAST DIV
Gannett GCI	\$81.00	10.4	1.3%	
Knight-Ridder KRI	66.43	9.6	2.1	
Tribune TRB	41.14	9.6	1.2	

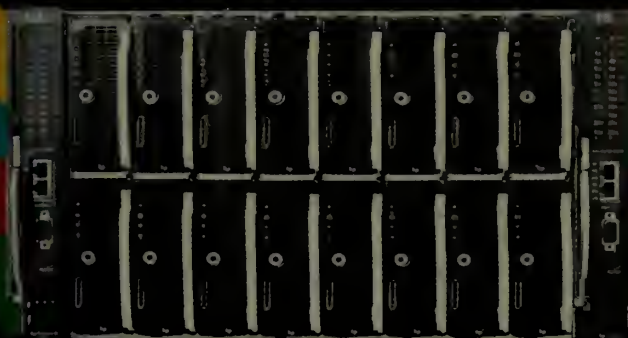
*Price as of Jan. 14 **Earnings before interest, taxes, depreciation, and amortization, 2005 estimates
Data: Company reports, Standard & Poor's, BusinessWeek estimates

recruitment-ad revenues—all three companies would be. Meantime, they have operating costs well under control. Knight-Ridder, for instance, notes that California's San Clara County, home to its *Mercury-News* in San Jose, still suffers from the bust of the Silicon Valley economy, having lost one job in five since 2000. The *Merc*, however, has cut full-time staff 22%.

A wildly bullish picture? No, but the market is valuing stocks at a modest 10 times estimates of 2005 earnings interest, taxes, depreciation, and amortization (EBITDA). Pulitzer, which is exploring a possible sale of the company, now goes for 13 to 14 times estimated EBITDA. One day Gannett has expressed interest in Pulitzer, based in St. Louis. If it makes a deal, uncertainty over the ultimate payoff could weigh on the stock. Investors might also pause over Gannett's disclosure on Dec. 30 that it had speeded the vesting of 1 million employee stock options, which benefits top executives disproportionately. Neither the company nor the chairman of the board's compensation panel, former Fannie Mae CEO James Johnson, would explain why the move was needed.

These worries make Gannett my least favorite of the three. Just the same, look for each to report surprisingly better results to shareholders. You read it here first. ■

E-mail: rb@businessweek.com



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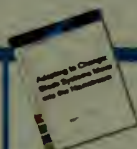


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1. Benchmarking is not a measurement of higher performance. 2. Based on internal HP testing; compared to similarly configured HP1U, 2P server. For configurator, please visit: <http://h30099.www3.hp.com/configurator/catalog-isspc.asp> through 4/30/05. 4. Receive up to 2TB of storage free with purchase of select HP StorageWorks MSA1500 devices. Offer ends on 3/31/05. See Web site for full details. Intel, Intel logo, Intel Inside, Intel Inside Logo, Intel Centrino, Intel Celeron, Intel Xeon, Intel SpeedStep, Itanium and Pentium are trademarks or registered trademarks of Intel Corporation or its subsidiaries in the United States and other countries. ©2004 Hewlett-Packard Development Company, L.P.

Personal Business Inside Wall Stre



BY GENE G. MARCIAL

THE SUN MAY SHINE ON **SCHLUMBERGER'S** PART OF THE OIL PA

DIETING FADS HAVEN'T CRIMPED SALES AT **J&J SNACK FOODS**

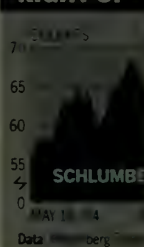
ARBITRON MIGHT BE BUYOUT BAIT FOR VNU OF THE NETHERLA

A Schlumberger Surge?

SCHLUMBERGER (SLB) HASN'T PARTICIPATED much in the oil-and-gas stock rally, because events such as hurricanes in the Gulf of Mexico and problems in Venezuela and Russia crimped earnings. But to Sarat Sethi at investment boutique Douglas C. Lane, Schlumberger is still the best energy bet. The spike in crude oil prices has stimulated drilling, boosting demand for its services, including seismic surveys and well completions. In the next couple of years, much of the spending on exploration, says Sethi, will be directed toward offshore and international projects, mainly in deepwater—where Schlumberger is “extremely strong.” Not only are the big oil companies spending again to find oil, but state-owned oil companies, especially in India and Mexico, are also increasing their exploration budgets, notes Sethi. Schlumberger has strong ties with many such state-run

enterprises, he adds. Brad Handler of Wachovia Securities, who rates the stock “outperform,” notes that the company leads peers in international exposure, with 70% of its revenues derived outside North America. In 2001, Schlumberger shifted strategy to provide integrated oil-field services; in 2003, it sold its noncore assets, including its semiconductor testing unit. With a renewed focus on driving up earnings, says Sethi, he expects “some upside surprises to its earnings.” That, he adds, should fetch a “premium valuation” for Schlumberger as a growth stock. Trading at 64—up from 55 in May—the stock should rise 75 to 80 in a year, predicts Sethi, based on his 2005 earnings forecast of \$2.75 a share, on sales of \$12.9 billion, and \$3.25 in 2006 on \$14.1 billion, up from \$2.10 in 2004.

PUMPING RIGHT UP



30 Blue Chips in one

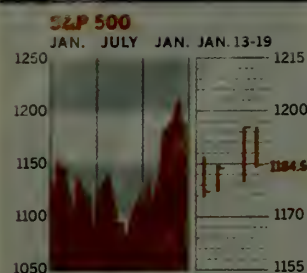
Diamonds (DIA) are all 30 gems of the Dow Jones Industrial Average wrapped up in one neat exchange traded fund. And of course, they are subject to similar risks. Ask your advisor for details. It's a smart way to add luster to your portfolio.



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STOCKS



COMMENTARY

Despite strong earnings from such outfits as IBM, Pfizer, and 3M and little news on the economic front, gloomy investors drove stocks steadily downward. On the positive side, however, gas prices nudged downward, although oil remains in the \$50-per-barrel zone. For the week, the S&P 500, Dow, and NASDAQ fell 0.3%, 0.7%, and 0.9%, respectively.

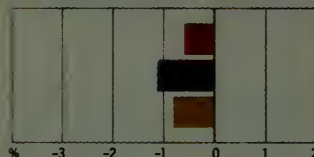
Data: Bloomberg Financial Markets, Reuters

MUTUAL FUNDS

4-WEEK TOTAL RETURN

WEEK ENDED JAN. 18

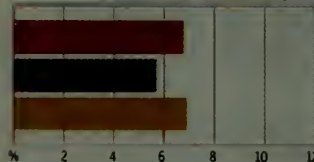
■ S&P 500 ■ U.S. DIVERSIFIED ■ ALL EQUITY



52-WEEK TOTAL RETURN

WEEK ENDED JAN. 18

■ S&P 500 ■ U.S. DIVERSIFIED ■ ALL EQUITY



Data: Standard & Poor's

U.S. MARKETS

	JAN. 19	WEEK	% CHANGE YEAR TO DATE	LAST 12 MONTHS
S&P 500	1184.6	-0.3	-2.3	3.9
Dow Jones Industrials	10,540.0	-0.7	-2.3	-0.6
NASDAQ Composite	2073.6	-0.8	-4.7	-3.1
S&P MidCap 400	640.4	0.7	-3.5	7.9
S&P SmallCap 600	315.3	1.3	-4.1	12.5
DJ Wilshire 5000	11,638.9	0.0	-2.6	4.7

SECTORS

	JAN. 19	WEEK	% CHANGE YEAR TO DATE	LAST 12 MONTHS
BusinessWeek 50*	698.6	-0.1	12.3	12.8
BW Info Tech 100**	357.6	-1.0	2.0	-2.4
S&P/BARRA Growth	570.7	-0.4	-1.9	0.2
S&P/BARRA Value	609.6	-0.1	-2.6	7.7
S&P Energy	290.2	1.7	0.5	29.8
S&P Financials	402.2	0.0	-2.2	3.5
S&P REIT	137.6	2.9	-4.8	19.3
S&P Transportation	221.5	-1.8	-8.3	11.7
S&P Utilities	140.7	1.8	-0.7	18.6
GSTI Internet	169.2	1.3	-5.1	8.9
PSE Technology	738.6	-0.4	-5.2	-1.2

*Mar. 19, 1999=1000 **Feb. 7, 2000=1000

GLOBAL MARKETS

	JAN. 19	WEEK	YTD
S&P Euro Plus (U.S. Dollar)	1394.4	3.2	-
London (FT-SE 100)	4818.3	0.7	-
Paris (CAC 40)	3869.0	1.4	-
Frankfurt (DAX)	4245.6	0.9	-
Tokyo (NIKKEI 225)	11,405.3	-0.4	-
Hong Kong (Hang Seng)	13,678.6	0.8	-
Toronto (S&P/TSX Composite)	9120.4	1.1	-
Mexico City (IPC)	13,035.8	5.7	-

FUNDAMENTALS

	JAN. 18	WEEK	YTD
S&P 500 Dividend Yield	1.94%	1.95	-
S&P 500 P/E Ratio (Trailing 12 mos.)	20.2	20.0	-
S&P 500 P/E Ratio (Next 12 mos.)*	16.2	16.1	-
First Call Earnings Surprise*	4.02%	6.91%	-

TECHNICAL INDICATORS

	JAN. 18	WEEK	YTD
S&P 500 200-day average	1133.4	1132.0	-
Stocks above 200-day average	75.0%	72.0%	-
Options: Put/call ratio	0.69	0.73	-
Insiders: Vickers NYSE Sell/buy ratio	5.35	5.80	-

BEST-PERFORMING GROUPS

	LAST MONTH %		LAST 12 MONTHS %
Fertilizers & Ag. Chems.	13.6	Fertilizers & Ag. Chems.	100.4
Drug Chains	10.7	Steel	61.7
Agricultural Products	7.1	Oil & Gas Refining	56.1
Health-Care Facilities	6.0	Internet Retail	54.0
Homebuilding	5.7	Managed Health Care	53.9

WORST-PERFORMING GROUPS

	LAST MONTH %		LAST 12 MONTHS %
IT Consulting	-13.5	IT Consulting	-
Electric Mfg. Svcs.	-11.2	Semiconductor Equip.	-
Air Freight & Couriers	-10.9	Electric Mfg. Svcs.	-
Application Software	-10.8	Semiconductors	-
Internet Retail	-10.2	Insurance Brokers	-

EQUITY FUND CATEGORIES

4-WEEK TOTAL RETURN	%	52-WEEK TOTAL RETURN	%
LEADERS		LEADERS	
Japan	5.0	Natural Resources	26.9
Diversified Pacific/Asia	3.1	Real Estate	26.7
Diversified Emerg. Mkts.	1.1	Latin America	24.3
Pacific/Asia ex-Japan	1.0	Utilities	19.2
LAGGARDS		LAGGARDS	
Precious Metals	-3.9	Technology	-10.8
Real Estate	-3.2	Precious Metals	-7.5
Technology	-3.1	Small-cap Growth	-0.4
Small-cap Value	-2.1	Large-cap Growth	2.4

EQUITY FUNDS

4-WEEK TOTAL RETURN	%	52-WEEK TOTAL RETURN	%
LEADERS		LEADERS	
T R. Price Em. Eur. & Mdn.	10.0	iShares MSCI Austria Idx.	52.3
Fidelity Advisor Korea A	10.0	CGM Realty	45.5
Matthews Korea	9.5	Alpine U.S. Rl. Est. Eq. Y	44.9
Japan Smaller Companies	9.2	Metzler/Pdn. Eur. Em. Mkt.	44.2
LAGGARDS		LAGGARDS	
Commonwith. N. Zind	-10.1	ProFunds Semicdr. Inv.	-46.4
Ameritor Investment	-9.1	Ameritor Investment	-44.4
Apex Mid Cap Growth	-8.7	Van Wagoner Sm. Cap. Gr.	-35.4
ProFunds Pr. Mtls. Inv.	-8.6	Rydex Electronics Inv.	-35.3

INTEREST RATES

KEY RATES

	JAN. 19	WEEK	YTD
Money Market Funds	1.81%	-	-
90-Day Treasury Bills	2.36	2.33	-
2-Year Treasury Notes	3.22	3.20	-
10-Year Treasury Notes	4.18	4.24	-
30-Year Treasury Bonds	4.66	4.77	-
30-Year Fixed Mortgage†	5.61	5.70	-

†Bank

BLOOMBERG MUNI YIELD EQUIVALENTS

Taxable equivalent yields on AAA-rated, tax-exempt municipal bonds, assuming a 30% federal tax rate.

	10-YR BOND	30
General Obligations	5.14	-
Taxable Equivalent	5.14	-
Insured Revenue Bonds	5.14	-
Taxable Equivalent	5.33	-

THE WEEK AHEAD

CONSUMER CONFIDENCE

Tuesday, Jan. 25, 10 a.m., EDT » The Conference Board's consumer-confidence index very likely fell to 102 in January from 102.3 in December. That's the median forecast of economists polled by Action Economics LLC.

EXISTING HOME SALES Tuesday, Jan. 25, 10 a.m., EDT » Resales of homes probably slipped to an annual rate of 6.89 million in December from 6.94 million in

November. Because mortgage rates stayed below 6% last year, 2004 saw another yearly record high set for home sales.

DURABLE GOODS ORDERS

Thursday Jan. 27, 8:30 a.m., EDT » December orders for durable goods probably rose 0.5%, after a 1.4% gain in November.

GROSS DOMESTIC PRODUCT

Friday, Jan. 28, 8:30 a.m., EDT » Real gross domestic product probably grew at an

annual rate of 3.3% in the fourth quarter, vs. a 4% pace in the third quarter, according to the median forecast compiled by Action Economics. A severe widening in the net-exports deficit was a drag on growth at yearend.

EMPLOYMENT COST INDEX

Friday, Jan. 28, 8:30 a.m., EDT » Compensation probably increased by 0.8% in the fourth quarter, just a notch below the 0.9% gain in the third quarter.

The BusinessWeek production index increased 0.5% for the week Jan. 8 and was up 11.9% from the previous year. Before calculating the four-week moving average, the index fell to 240.5 from 242.7.

BusinessWeek

For the BW50, more investment data, and the components of the production index visit www.businessweek.com/magazine/

the Companies

Index gives the starting page for a story or feature with significant reference to a company. Most subsidiaries indexed under their own names. Companies listed only if they are not included.

Capco **80**
 Capital Group **80**
 Celanese **78**
 Charter Communications (CHTR) **40**
 Chiron (CHIR) **54**
 Chrysler (DCX) **14, 76, 100**
 CIMI **58**
 Cingular Wireless **20**
 Cisco Systems (CSCO) **14, 22, 58**
 Citigroup (C) **18**
 Clear Channel (CCU) **96**
 Comcast (CMCSK) **32**
 Credit Suisse First Boston (CSR) **50, 80**
 Crist Associates **11**

D
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 Dell (DELL) **16, 32**
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 Diffusion Group **32**
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E
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 Postmaster: Send address changes to BusinessWeek, P.O. Box 53235, Boulder, CO. 80322-3235.

How Nations Can Age Gracefully

DEMOGRAPHY IS NOT DESTINY. As the debate over aging gets under way around the world, it would be wise to keep that in mind. In the U.S., President George W. Bush is making reform of Social Security a key goal of his second administration. In Germany and most of Europe, there is angst over how to pay growing numbers of pensioners. In Asia, there is apprehension about aging populations in Japan and China. At the upcoming World Economic Forum in Davos, Switzerland, global aging will be high on the agenda. The big fear is that aging populations will bankrupt governments, erode economic vitality, and even harm geopolitical strength. Such a fear is wildly exaggerated.

The truth is that relatively small changes in the rates of growth for productivity and immigration can sharply reduce the impact of demographics on a country's economy. Small extensions of the working life by two or three years can significantly reduce the huge expense of retirement.

The real problem with aging is politics, not demographics. How do ethnically homogeneous countries such as Germany or Japan open themselves to immigrants? How do the French and Italians, who expect to retire in their fifties, accept years of additional work? How do Americans agree to cut or delay the benefits from Social Security and Medicare (page 44)?

Countries face difficult choices ahead as they navigate the aging of their populations. But there is nothing in their future to stop them from succeeding, except the lack of political will.

Don't Pass the Buck on Pensions

THE BUSH ADMINISTRATION is trying to bolster the Pension Benefit Guaranty Corp. by raising premiums. It's a step in the right direction but not nearly sufficient. The PBGC insures the pensions of 35 million Americans. But lately it has been insuring the financial success of turnaround specialists who buy weak companies with big legacy costs, dump their pensions on the PBGC, and flip the assets for hefty profits. We applaud these entrepreneurs as they consolidate steel and move into airlines, textiles, and other

industries, but question why they reap all the benefits while the PBGC gets saddled with the costs. It's time for the take equity stakes in the companies it helps.

Ownership and sales of equity in once-bankrupt, now refurbished companies would help close the PBGC's \$2.5 billion deficit and allow it to play its de facto industrial policy role in financing the consolidation of key segments of the American economy. This role is becoming increasingly untenable for the PBGC. The base of corporations paying the premiums for pension insurance is shrinking as companies shift from defined-pension plans to 401(k)s. Fewer companies are paying more to insure millions of workers. But should they be subsidizing entrepreneurs as well? We don't think so.

When the government bailed out Chrysler Corp. two decades ago, it demanded an equity kicker for the loan. When it offered loan guarantees to the airlines after September 11, it made equity part of the deals. If the PBGC is to play a central role in making the U.S. economy more efficient, it should demand no less. Equity is the answer.

Iraq: Bravery and The Ballot

DYING FOR DEMOCRACY is something Americans are brought up to respect and perhaps expect in their lifetime. It is not, however, part of the Iraqi tradition, which makes the image of Iraqis dying for democracy so powerful today. However misleading the reason for the U.S. invasion of Iraq, however incompetent the ensuing occupation, the overthrow of Saddam Hussein is opening the way to a genuine election, and the majority of Iraqis appear willing, even eager, to participate. Candidates, women as well as men, have been attacked and killed yet they continue to campaign. Polling stations have been bombed yet people continue to register to vote. However tainted the U.S. invasion of Iraq may appear, especially in Europe, it is time to recognize by the end of January the country will have its first legitimate election in modern history (page 49).

Certainly there is much reason for caution. A society with little civil structure left and no experience in parliamentary politics doesn't have a solid foundation for democracy. The Sunnis who dominated the Shia majority and the Kurds centuries lead a vicious war to thwart elections. And it is that once held, elections produce a theocracy, not democracy.

Yet despite the murders and the mayhem, Iraqis say they will vote if they can. In Afghanistan, millions of people with a tradition of voting, under threat from the Taliban, surprised the world by going to the polls. The election had meaning for them. So it appears in Iraq. However they have come up with the most Iraqis want to participate in a free election. The world should recognize and applaud their courage.



aw-Hill Companies

BusinessWeek

005

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One of these Honda CG125 motorcycles is a Chinese knockoff.*

FAKES!

The global counterfeit business is out of control, getting everything from computer chips to life-saving medicines. It's getting so bad that even China may need to crack down. **BY FREDERIK BALFOUR (P.54)**

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The real one is on the left*

It's an age-old problem, writ new. Who's going to build an environmentally friendly fleet of hydrogen-powered vehicles without the energy stations in place? But who'll invest in

hydrogen energy stations before enough vehicles are on the road to make it worthwhile? So which comes first, the chicken or the egg? At ChevronTexaco, we're jump-starting

Chicken...



www.chevrontexaco.com/hydrogenenergy

s by partnering with the US Department
nergy and AC Transit of California.
her, we're integrating new technologies
he existing natural gas distribution network

to create a prototype hydrogen energy station,
open for business in 2005. By using this
practical approach to build stations, we're well
on our way to building a better tomorrow.

meet the egg.



ChevronTexaco

Turning partnership into energy.™

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CRUSHING BURDEN

Authorities can smash all the fake goods they want, but they're losing the war on counterfeits, now global in scale



Cover Story

54 Counterfeiting's Rise

When a fast-growing industry hits \$500 billion in sales, it's time everyone took notice—especially when it's illegal. Maker fakes have moved beyond Rolex watches to cars, computer chips, and life-saving medicines. Counterfeiters are so proficient that it can take an expert to spot the knockoff. The situation is out of control, and even China may be forced to crack down

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Networking giant is poised to rule
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Accenture and the World Economic Forum.

The World Economic Forum is committed to improving the state of the world through partnership between business and society — and Accenture is proud to have been a strategic partner for nine years.

The theme of this year's World Economic Forum Annual Meeting is Taking Responsibility for Tough Choices. At a time when leaders from business, politics and wider society are facing an unparalleled degree of complexity, they will come together to discuss practical ways to cooperate and harness their experience and knowledge.

But the World Economic Forum is much more than a platform for discussion. Accenture has been actively involved in several of the Forum's key initiatives — addressing issues from corporate citizenship and the digital divide to global health. And we are proud of the very real achievements that our collaborative work has produced.

Additionally, in our role as a strategic partner, we help to deliver the leading-edge technology solutions that allow participants to stay connected and informed at the Forum's Annual Meeting.

At Accenture, we are committed to teaming with businesses and governments to deliver innovation that will help achieve high performance. You can learn more about Accenture's strategic partnership with the World Economic Forum and our perspectives on high-performance business by visiting accenture.com

A dramatic, low-key photograph of Tiger Woods in the middle of a golf swing. He is wearing a dark polo shirt with a small white Nike swoosh on the chest and a dark visor with the word "one" on it. His right arm is extended upwards, and his head is tilted back, looking towards the sky. The background is dark and out of focus, suggesting a night or dusk setting.

Do you test the wind?
Or do you use it?

Go on. Be a Tiger.

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"HENDRICK'S" WON

THE GIN CATEGORY™.

- THE WALL STREET JOURNAL

THE WALL STREET JOURNAL

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FRIDAY, AUGUST 29, 2003 - VOL. CXXIII NO. 43 - ***** \$1.00

When it came to our tasting of "white goods," the superpremiums ruled the day. Here, our top three in each category, plus our tasters' comments:

LIQUOR BRAND/PRICE* OUR AWARD

TOP 3 GINS

Hendrick's Most
\$30/750ml Flavorful

Tanqueray No. Ten Smoothest
\$26/750ml

Juniper Green Organic Best
\$26.50/750ml Presentation



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General Electric Starts Playing To Its Strengths

While some may question the quality of its earnings, a look inside the numbers shows that a series of bets made by CEO Jeff Immelt and his team are beginning to pay off for the industrial giant

When Business Is in the Blood

It's a new—and tougher—world for family-owned companies. This Special Report takes a look at how the large and small are coping—and thriving. Plus: What successful successions need; how the Buck Knives clan stays on the cutting edge; and lots

The Chipmakers Get Ready For a Laptop Rumble

Intel has jumped to a big lead over Advanced Micro Devices in the growing and lucrative market for notebook chips. But according to AMD CEO Hector Ruiz, the competition is about to get a lot tougher

A Year for the Choosy Buyer

Standard & Poor's analyst Kenneth Shea sees "solid positive momentum" for the economy and the market in 2005. But with no one sector likely to be the year's standout star, he urges the greatest care when picking individual stocks

Will Europeans Warm To Starbucks?

France's different coffee-drinking culture and the loss of a German partner are Continental challenges for its aggressive expansion plan

»VIDEO

Original streaming video featuring industry experts and BW editors

»TOOLS

Your Portfolio, Stock Screener, MBA Search, and Mutual Fund Scoreboards

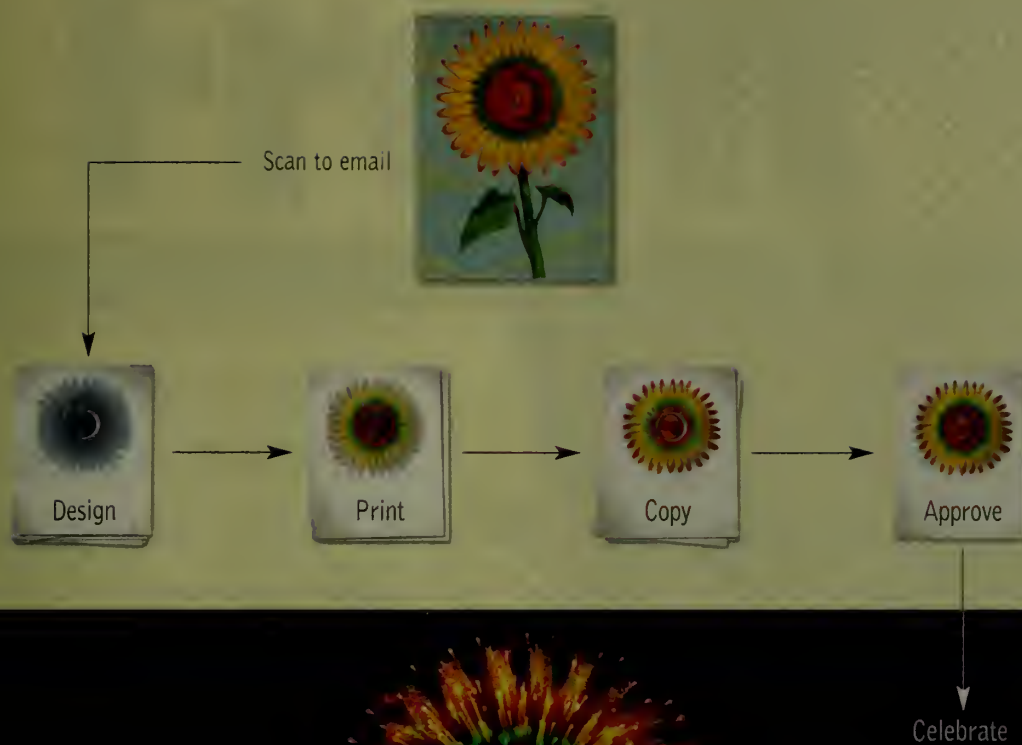
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“Citrix helps HP increase productivity by giving our employees easy and secure access to standardized business-critical applications from anywhere in the world.”

Gilles Bouchard, CIO
and EVP of Global Operations
Hewlett-Packard Corporation

access

INFRASTRUCTURE FOR THE ON-DEMAND ENTERPRISE

As a constantly expanding global corporation, HP faces a variety of IT challenges to ensure that 145,000 employees around the globe have access to the bandwidth-intensive applications they need to do their jobs. HP's global operations require access to critical applications in far-reaching corners of the world and deployment of applications across a diversity of platforms. So HP did what 99% of the *Fortune* 500 have already done. They turned to Citrix. Now HP is able to provide its employees with secure access to information — regardless of location, platform or device used. Citrix is helping HP — and 120,000 other customers — save money and reduce IT complexity. We call it the on-demand enterprise. To learn what Citrix can do for your business, call 888-820-7918 or visit www.citrix.com

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JP Front

"They own everything. That's why I went into the restaurant business."

—Ted Turner, on big media companies and their continuing consolidation

BY IRA SAGER

GFESTS

S PARTNERS RSUS RTNERSHIP

D PARTNERS in law and
ing firms be entitled
if they face age, race, or
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employment
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n (EEOC)

recent suit it
ht against **Sidley Austin
& Wood**, one of the
s largest law firms.
gency charges that the
lawyer firm discrimin-
against 31 former

partners over age 40 who
were demoted or forced to
leave in a 1999 restructuring.

Sidley says that the EEOC's
charges have no merit
because the firm's partnership
status exempts it from federal
discrimination law. But the
EEOC is questioning the
Sidley partnership and
maintains that the firm is run
by small management



committees—like
most other big law
and accounting
firms.

Sidley partners
do share profits
and loss liabilities,
so the outcome
isn't clear. But "if
the government
wins, it could put all large
partnerships at risk of
lawsuits," says Mark Dichter,
a partner at **Morgan, Lewis &
Bockius**, which isn't involved
in the suit. —Aaron Bernstein



ROTAVIRUS
Glaxo has launch
a vaccine in Mexi

CHARITY CASES

Aiding Mankind— And Drugmakers

VACCINE MAKERS ARE GETTING A BOOST from the Bill & Melinda Gates Foundation. On Jan. 24, the Gateses gave \$750 million to the **Global Alliance for Vaccines & Immunization (GAVI)**—their second contribution. The money, spread over 10 years, guarantees the \$7 billion vaccine industry a big market. Says Gates: "We're going to be buying a lot of vaccines."

Already, GAVI has helped speed vaccine rollout. Companies typically introduce new vaccines in wealthy nations—waiting years, even decades, before taking vaccines to the developing world. But with funding and distribution help from GAVI, **GlaxoSmithKline** has just begun selling its vaccine for rotavirus—which causes diarrhea and dehydration, and kills 500,000 children a year—in Mexico first. **Merck** will shortly follow suit. Dr. Adel Mahmoud, head of Merck's vaccine unit, says GAVI proves "there's a market and funds."

Governments, too, have been spurred by the Gates largesse. Norway pledged \$290 million to GAVI this week, and Britain is considering a \$1.8 billion pledge. GAVI's aim to inoculate 90% of the world's poor by 2015 would save an estimated 10 million lives. To meet such demand, vaccine makers could see double-digit growth for years to come.

—Jessi Hempel

BIG PICTURE

ER BETS Since both Super
teams are wildly popular,
Vegas bookmakers say
year's action will top
4's record, despite Internet
ering's growing popularity.

IONS OF DOLLARS

ONEY WAGERED ON THE SUPER BOWL*



'01 '02 '03 '04

Nevada Gaming Control Board, BusinessWeek

*BETS PLACED IN-PERSON AT NEVADA'S 152 SPORTS BOOKS

WEB WATCH

THE LID ON SPAM IS STILL LOOSE

IT HAS BEEN a year since Congress passed, with much ado, the CAN-SPAM Act, which set restrictions on unsolicited e-mail. But the law, which took effect on Jan. 1, 2004, has done little to stop junk messages. In fact, a new report by e-mail security outfit **MX Logic** says 97% of unsolicited commercial e-mail still flouts the law.

Forgive industry experts if they say: "I told you so." The law does not address the underlying technology that aids spammers. "They invade PCs or bounce the messages from host to host, making it almost

impossible to get to the source," says Andrew Lochart of e-mail security provider **Postini**.

To be sure, a handful of unlucky spammers are being prosecuted. On Jan. 13, the Texas attorney general filed the state's first CAN-SPAM lawsuit against **University of Texas** student Ryan Pitylak, the head of the world's fourth-largest spam ring, according to watchdog

agency **Spamhaus**. Pitylak didn't return calls.

Still, "people should not have a false sense of comfort from any statute that purports to crack down on this," says a spokesman for California

Attorney General Bill Lockyer. Indeed, judging by the traffic, most spammers are staying one step ahead of the law. —Erin Chambers

75%

The portion of all e-mail traffic in 2004 that was spam.

Data: Nucleus Research

RETAIL DETAIL

A GIANT TAKES ON PETITE

In a big step into a small niche, Gap's Banana Republic chain is planning its first stores catering to women 5 ft. 4 in. and under, *BusinessWeek* has learned. The stores, to be called **Banana Republic Petites**, will open in Boston, Los Angeles, and Seattle in February. Like other apparel chains, Banana now stocks only a limited petite selection at its 440 outlets. Banana, making up 13% of Gap's estimated \$16 billion in sales, won't say how many Petites stores it's planning. After sales gains through 2004, Banana's progress slowed lately. Giving petite customers a place their own could help it sell more of those crepe suits and little black dresses. —Louise

TECH WATCH

WILL A 'JUNK' RATING SINK THE DEAL?

TECH OUTSOURCING may be ripe for consolidation. Half the 150 CIOs surveyed by **Merrill Lynch** say they won't do deals with firms with "junk" credit ratings, which includes **Electronic Data Systems**, **Capgemini**, and **BearingPoint**.

The concern: Staying power—since deals are multiyear. The weaker companies risk falling into a "downward spiral," making them vulnerable to consolidation if they can't cut deals, says Merrill analyst Gregory Smith. Those with junk ratings say the designation hasn't hurt their ability to win contracts. —Andrew Park

DRAWN & QUARTERED



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ROBERT LUTZ



THE BLOG FROM THE RUST BELT

If you had to guess the name of a big-time executive with his own blog, who would come to mind? Apple's Steve Jobs? The Google guys? How about a 72-year-old auto exec in rusty ol' Detroit? General Motors new-car czar **Robert Lutz** started a blog at www.fastlane.gmblogs.com with a mission to gin up enthusiasm for new GM cars and parry the jabs of critics.

In other words, Lutz is doing a little PR. Lutz does his own writing, but his staff selects e-mails from his 4,000 daily visitors for him to answer. Lutz, for instance, replied to charges that the two stylish new Saturn models that GM displayed at the Detroit auto show wouldn't have as much pizzazz when they hit later this year. Lutz countered that they are production-ready.

That's about as provocative as it gets. But stay tuned: As Lutz, who declined to be interviewed, wrote in his first blog on Jan. 5: "After years of reading and reacting to the automotive press, I finally get to put the shoe on the other foot."

—David Welch

TOXIC TECH

EUROPE SAYS: LET'S GET THE LEAD OUT

THE GLOBAL electronics industry is facing tough new environmental regulations that will require the redesign of thousands of products from TVs to cell phones. Two directives from the European Union that limit the use of toxic substances in electronics and require manufacturers to pay for recycling used goods are set to go into effect in the next 18 months.

Under the new rules, electronic equipment must be free of lead and other heavy metals. Companies also have to navigate as yet murky rules for collecting, disassembling, and disposing of old gear. "We can't estimate how much this will cost us," says Claudia Martens, corporate affairs manager at **Hewlett-Packard**, Europe's No. 1 PC seller. Brussels-based electronics trade group **Orgalime** figures the new requirements could cost the industry \$40 billion for redesign, retooling, and



CRASHED
COMPUTER
leak nox
chemical
into land

recovery of waste, plus another \$3 billion in ongoing annual costs.

The directives are aimed at the growing tide of e-waste and noxious chemicals pouring into landfills across Europe. This summer, companies will have to start recovering old products. And by July 1, 2006, six substances, including lead, cadmium, mercury, and chromium-6, will be banned in almost all electronics products. That could have a profound effect on the industry because nearly every product on the market uses lead-based solder to secure chips to printed circuit boards.

Manufacturers such as **Nokia** and **Philips Electronics** plan to apply the standards worldwide to avoid duplication of their product lines. So do U.S. companies such as **HP** and **Dell**, which say they'll be ready in time, but worry about logistical hiccups. Europe's greener policies have even been copied by China. "Everyone is following Europe's lead on this," says Greg Monty, director of corporate relations at **Underwriters Laboratories**, Northbrook, Ill.

One big exception: the U.S., where a few dozen states such as California and Massachusetts ban lead and require recycling. But that could change as the waste problem grows. Market researcher **Gartner Group** forecasts Americans will replace or retire 133,000 computers per day this year alone.

Activists also are turning up the heat: Protesters at a recent Macworld show in San Francisco put up a banner reading "From i to iWaste," to highlight the difficulty of replacing and recycling batteries for the popular digital music players. Looks as if electronics makers will face more green mandates in years to come.

—Andy Rein
and Rachel Ti



4% of Europe's yearly waste is electronics, but it's growing three times as fast as other trash categories.

11% of all discarded computers are recycled worldwide. Mobile phones are worse: only 5%.

40% of the lead in landfills comes from electronics gear, which is a tiny part of solid waste.

Data: European Union; U.S. Environmental Protection Agency



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“The New York Times is not just another corporation, but a one-of-a-kind institution of far greater importance.”

—Bernard Loomis
 Palm Beach Gardens, Fla.



WHAT NEW YORK TIMES READERS REALLY WANT

I AM 82 YEARS old and have been a *New York Times* reader for most of them (“The future of *The New York Times*,” Cover Story, Jan. 17). On its worst day, *The New York Times* has been the best newspaper in the world. Neither the Jayson Blair nor the Howell Raines experiences nor anything else have been more than momentary scratches on the long-established, long-earned, and long-deserved stature of the *Times* as an extraordinary institution of extraordinary importance to our country and the world. *BusinessWeek* dares to suggest that the wonderful tradition of the Ochs-Sulzberger family—past, present, and future—in recognizing the far greater importance of the *Times* as a newspaper is less important than the current multiple of its stock.

I fully recognize the need for the *Times* to continue to be a profitable business and to expand its role in the world of communications. But I am certain of, and I am proud of, the Ochs-Sulzberger tradition that I know will ignore the world of pressure for higher multiples—and will do everything to sustain the reality that *The New York Times* is not just another corpo-

ration but a one-of-a-kind institution of far greater importance.

—Bernard Loomis
 Palm Beach Gardens, Fla.

WHAT I FIND LEAST compelling about Arthur Ochs Sulzberger Jr.’s position of *The New York Times* is his assertion that news coverage in this paper is shared between an “urban environment” and “a blue state vs. blue state” politics. I subscribe to the *Times* not because I agree with its politics, but because I strongly disagree. *The New York Times* is clearly Fox News’ head, which is why I continue to read it through a daily ritual of reading the *Times*, and kick back to relax with the *Wall Street Journal* while watching O’Reilly and Sean Hannity.

—Matthea
 New York

AS A CENTRIST, I HAVE watched with dismay how the *Times* switched from center-left toward the left. The editorials lost their equilibrium, the feckless columnists have turned tiresomely marginalized, except for Thomas Friedman and David Brooks. I thought I did not vote for George W.

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Readers Report

CORRECTIONS & CLARIFICATIONS

The Motorola Inc. phone described in "When a BlackBerry is overkill" (Technology & You, Jan. 31) is the MPx220, not the MPx200. And the column incorrectly stated that the Motorola phone and Audiovox SMT5600 lack speaker-phones. Also, in "Motorola sharpens the Razr edge" (News: Analysis & Commentary, Jan. 31), the photo table descriptions of the Razr V3 and the E815 were transposed.

The NexBio drug described in "Coming Soon: A Flu Vaccine For All Seasons" (Developments to Watch, Jan. 24) doesn't block a receptor on cells, as stated. It removes the receptor.

ARTHUR SULZBERGER Jr.'s dilemma to whether online readers of *The New York Times* should pay a fee should be the Gray Lady has yet to catch up to reality. What Sulzberger does not appreciate is how many online readers are also subscribers. I prefer to read the *Times* rather than scamper about my laptop to find where the paper has been. I leave it for the family to read. I am not anyone who reads the *Times* know the advantage of the online edition is that it does not come off on the reader's screen.

—Donald E. Broderick

ARE YOU TELLING ME that in the world in which information is king that the Audit Bureau of Circulations for *The New York Times* knows how many papers sold in 2003 were distributed within and outside of the New York area? I work for an airline, and I can tell you with absolute certainty that we know where our 2003 customers boarded airplanes and where we took them.

—Michael J. Tyron

HERE'S AN IDEA to help *The New York Times* boost print circulation: come up with a really good assortment like *The Washington Post*, instead of the puny page half found in *The Boston Globe*.

—Bradley Newton

THE TROUBLE WITH THE U.S. SAVINGS RATE

RE MICHAEL MANDEL'S commentary "Our hidden savings" (News: Analysis & Commentary, Jan. 17): The pitiful personal saving rate in the U.S. is good for creating financial hardship for tens of millions of seniors in the next few decades. The ratio of payroll taxpayers to Social Security beneficiaries will fall from 3 to 2 to 1 over the next 25 years. The system will have to be revised, and the eligibility will have to be increased or higher. Thus, people will have to rely more heavily on their personal nest eggs, and this is the problem. Although Mandel shows that household wealth is now down to where it was five years ago, we have a highly skewed distribution in this country. Data show that the wealthiest 20% of households own over 90% of household net worth, and the remaining 80% of households own less than 10%. Most boomers will still be working in their 70s and 80s.

—Edward M. Sykes

Gulf Stream

Editor's Note: The writer is former

I resent the unbalanced reporting during the election. A publisher's personal biases have no place in a newsroom.

—Frederic Goldsmith
New York

I STARTED PICKING UP *The New York Times* when I traveled extensively in my job. I truly looked upon it as a "national newspaper." When my traveling slowed, I had a subscription delivered to my home. As I often remarked, I got the *Times* for the news and Baltimore's *The Sun* to see what was on sale and what was playing at the movies. I knew that the *Times* was blatantly liberal but accepted that as long as it was primarily confined to the editorial pages. About three years ago I noticed a shift. I canceled my subscription this summer when I could no longer accept the paper's obvious liberal stance in all its sections.

Arthur Sulzberger Jr. should confine his liberal stance to the editorial page—which as a reader I can choose to read or not read. Otherwise, *The New York Times* will become a second-rate, politically oriented paper, not unlike the Baltimore *Sun*, another paper with a grand tradition that is a mere shadow of its former self.

—Sal Castorina
Baltimore

ANTHONY BIANCO missed one of the major revenue holes that both *The New York Times* and *The Boston Globe* have suffered. A look back at the sheer size of their voluminous and very profitable Sunday "Help Wanted" sections in the mid-to-late '90s vs. the meager presences that they are today, speaks volumes. The trouble? They have gotten eaten by a monster—www.monster.com!

—James J. Treacy
Glen Rock, N.J.

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Water treatment facilities

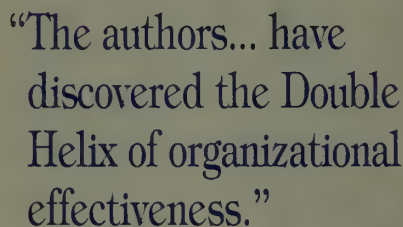
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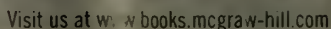


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THE MEASUREMENT of savings is a statistical minefield, and it is possible to come up with many alternative definitions that show a higher savings rate than the official measure. A key U.S. problem is that domestic savings are insufficient to finance domestic investment, forcing the U.S. to rely excessively on borrowing from abroad. If investment and thus savings are understated by an equal amount, then this problem is unaffected.

GOOD POLICY GOT RID OF DEFICITS IN THE 1990s

IN "CBO CHIEF WARNS: Time to choose" (Capital Wrapup, Jan. 17), you assert: "Of course, the U.S. grew its way out of huge deficits in the '90s." If only it were that easy. Actually, what turned deficits to surpluses were the politically brave efforts of the first President Bush and President Bill Clinton, each of whom worked with a Democrat-run Congress to enact five-year packages of about \$500 billion in tax increases and spending cuts. The roaring economy of the '90s, producing tax revenues beyond expectations, surely enhanced the effort. But responsible fiscal policy helped cut interest rates, thus fueling the strong economy in the first place. The record deficits of that time would not have simply disappeared in the absence of good policy.

Editor's Note: The writer was communications director to the Office of Management & Budget under President Clinton.

“WANTED: NEW WEAPONS against an old killer” (International Business, Jan. 17) is correct in stating that malaria kills about 1.5 million people per year. I’m surprised that the authors did not mention returning to the use of DDT. No chemical in history has saved more lives than DDT and few, if any, have a better safety record. The world has searched for a new weapon against malaria for over 30 years. None have been found as effective as DDT or as inexpensive, and some have significant side effects.

Readers Repc

"DEATH, TAXES, AND Sarbanes-
(News: Analysis & Commentary, Jan. 11)
a good summary of where business
today. However, a bigger ques
whether such regulations address
struction of shareholder value.
analysis by Booz Allen Hamilto
shows that more shareholder val
destroyed between 1998 and 20
strategic mismanagement and po
cution than was lost in all the com
scandals combined. Only 13%
stroyed value came from complian
ures, while 87% was the result of st
and operational errors. Regulator
have missed the mark, but we see
leadership moment for business in

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Books

Globalization, 182

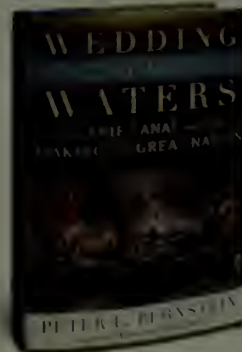
WEDDING OF THE WATERS The Erie Canal and the Making of a Great Nation
By Peter L. Bernstein; Norton; 448pp; \$24.95

A book about a 363-mile-long ditch dug through the middle of New York State almost 200 years ago and still used much since the 1950s? At first it seems an odd choice for Peter L. Bernstein, an economist and the author of the best-selling *Against the Gods: The Remarkable Story*

of Risk. But to Bernstein, the Erie Canal was more than a manmade waterway between Buffalo and Albany that afforded access to New York City via the Hudson River. It was an early step toward globalization and a worldwide complex of transportation routes that today "is the glue that binds the world together." In the end, Bernstein's deft writing and deep understanding of global economic history makes *Wedding of the Waters* not just a convincing brief for the project's importance but a fun read as well.

The book starts out with an almost too exhaustive review of the history of canals, beginning with those built by the Babylonians in 2200 B.C. Then it takes up the early trials of finding a route that would tie the original 13 states to the growing populations west of the Appalachian Mountains. New York was not the first state to seek a link between the cities and ports of the Eastern seaboard and the livestock and wheat farms of what's now the Midwest. In 1785, Virginian George Washington pursued his own scheme, using the Potomac River Valley.

The Potomac project was unable to overcome geographic hurdles, however, and in the end it would be the Erie Canal that provided the link, passing through the Appalachians via the Mohawk River gorge. But before the canal would open in 1825 it would take nine decades of research and argument and a final 15 years of sharp political maneuvering by New York statesmen, including Governor



The Erie Canal and its financing broke new ground

DeWitt Clinton and presidential legislator (and later President) Martin Van Buren. Manifest Destiny aside, an economic argument carried the day: Bernstein cites an 1808 estimate by engineer and steamboat pioneer Robert Fulton that 100 miles along the canal could be built for \$1. By road the cost was 10 times that.

The canal wasn't the place where new ground was broken. Financing for Erie was unconventional. The U.S. had yet to develop a public bond market. The federal government had begun footing the bill for interstate transportation, the banking system, the starting to grow, was

limited to lending based on gold in vaults. Debtors' prison was the stop for the overstretched—and more than one of the players in Bernstein's book ends up there.

In the early 19th century, it was wealthy individuals who financed projects. Recognizing that such resources alone would be insufficient for a project so large, the Erie's promoters pioneered a new form of finance: backed bonds supported by the anticipated revenue stream from canal tolls. These canal bonds were issued around the time that New York Bank for Savings was established, aiming to encourage the working class to save money. Through it the bond came to be widely held by ordinary people. "Like a beach composed of fine pieces of sand," Bernstein writes

...k pooled enough of these little
...to become one of the largest
...s in canal loans."
...stein's writing shines in these
...s on finance. Somewhat less
...are lengthy sections devoted to
...battles that supporters—
...arly DeWitt Clinton—had to win
...he canal could be built.
...Erie was pivotal to the
...ment of New York City, among
...aces. Before the canal,
...lphia was the nation's largest
...r and importer. By 1830, only five
...ter the canal opened, New York's
...had grown to four times those of
...Bernstein also credits the canal
...ch of the growth of Ohio. In the
...writes, the Erie Canal changed

the axis of the country from North-South to East-West and opened up trade to Europe on a whole new level.

One of the book's treats is its detail about life in the early 1800s. In our world of tightly guarded limos it's hard to imagine that the U.S. President once traveled unaccompanied on horseback. Nor is it easy in an era of sound bites to appreciate the depth of knowledge that once backed popular political debate—or the sophistication of the debaters' language. This was a canal dug by hand that would become a keystone of U.S. culture, inspiring plays, songs, and poems. With all the progress America has seen, it's bittersweet to consider some of the valuable things we have lost. ■

—By Nanette Byrnes

ief

What I Buy

OF REBELS
Counterculture Became Consumer

by Joseph Heath and Andrew Potter;
Business; 358pp; \$14.95

...the flower children of the
...those the nonconformist
...any of them traveled in
...ning Volkswagen bugs.
...ter, after hippies
...yuppies, they made
...ling sport-utility
...s their wheels of choice.

...change? Not really, say
...an philosophy
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...Potter in *Nation of*
...Why Counterculture
...Consumer Culture.

...kids of the '60s bought
...V's sales pitch: Show
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...ag, say the authors,
...people weren't really rebelling:
...d, like previous generations, they
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...ses. It was only a short jog to the
...ic Escalade.

...t counterculture is still around,
...influence can be seen on the
...al left and among alternative-
...e advocates, say the authors. But
...m challenging the system, they
...e, its tenets instead serve to

reinvigorate consumer capitalism.

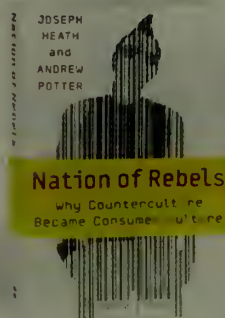
Heath and Potter are hardly the first to observe the role that an *avant garde* plays in setting styles. And they echo the work of early-20th century social critic Thorstein Veblen with the reflection that all purchases beyond the basics serve as "markers of social status." Moreover, this book is slow to get going, taking 60-plus pages to detail the evolution of the coun-

tercultural movement from its roots in France 200 years ago. All the same, *Nation of Rebels* provides an incisive and witty indictment of consumer trends, from the fad for exotic travel to "holistic" medicine.

Self-defined social progressives Heath and Potter also offer some political observations. In addition to favoring certain products, they note, the counterculture advocates rejection of the "system" as a whole. But this, say the authors, has simply made it politically irrelevant. For example, many activists seek the total elimination of the global trading system. Instead, say the authors, militants

should focus on reformable imbalances, such as agricultural subsidies. People should work to restrict capitalism's "antisocial" aspects, such as monopoly pricing. And, of course, they should place less emphasis on what they buy. ■

—By Kate Hazelwood



How kids graduated from VWs to SUVs

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BY STEPHEN H. WILDSTROM

Fighting Spyware: Microsoft to the Rescue

Spyware—software installed on your computer without your knowledge or consent—has overtaken viruses as the biggest security threat facing Windows computer users. With diligence you can avoid virus infection. But just a visit to the wrong Web site can load your PC with software that changes your browser home page, spews ads, or even steals passwords.

Microsoft's decision to jump into the fast-growing market for anti-spyware utilities is ironic. Spyware took off mostly because a multitude of flaws in Windows and the Internet Explorer browser let the bad guys sneak nasty software onto PCs. Windows XP Service Pack 2, last summer's overhaul of Windows, helped, but it didn't cure the problem.

The new Microsoft AntiSpyware is available in a test, or beta, version, for free download. It's a hastily repackaged version of a program acquired in Microsoft's December purchase of Giant Company Software. It looks like a solid program, though security software is hard to assess without detailed technical analysis. It's more user-friendly than the leading free anti-spyware products, Lavasoft Ad-Aware and Spybot Search and Destroy, and it does a good job of telling you what it's doing and why. For example, if you install the Google Toolbar, it notifies you that a new program changed browser settings but was allowed to because it is known to be safe.

THE MICROSOFT PROGRAM DIFFERS from most others by not raising alarms over "tracking cookies," small files that can let Web sites monitor your browsing activity. The handling of these cookies is controversial because they can steer you to information you want—or pass personal data to third parties without permission. But you don't need AntiSpyware to manage them; you can just set preferences on your browser.

For the most part, Microsoft has resisted a temptation it often succumbs to—making its products promote other company offerings. But if spyware hijacks your IE home page, AntiSpyware will reset it to msn.com. The program only protects IE, not other browsers. And it tries to make sure that the copy of Windows on the PC is properly licensed, an action that adds awkward steps to the installation and does more to protect Microsoft than consumers. Product manager Paul Bryan says these features may change in the course of testing.



Even if the program improves, I have serious qualms about Microsoft's entry into the security market. The company says it has not yet decided whether it will give AntiSpyware away or charge for it. Microsoft's move would help Microsoft promote its security software, helping consumers protect their machines.

On the other hand, giving it away for free would be good for overall security. Windows would be a lot less secure if it weren't for the independent software makers that have made a business out of cleaning up Microsoft's messes. Big diversified players such as Symantec and Computer Associates

Independent players that have made Windows more secure could suffer

International and spyware specialists such as Webroot Software and Sunbelt Software all could suffer if AntiSpyware is free. Just by entering the market, Microsoft "could freeze out other independent makers of spending of risk capital on Windows security," warns Michael Freund, CEO of firewall publisher ZoneLabs, a unit of Checkpoint Software Technologies. And if Microsoft achieves dominance, it often stops innovating, as has happened with IE.

For now, however, the important issue for consumer businesses remains protecting their PCs. First, make sure Microsoft's Windows Update is turned on. (Mac OS X users should make sure automatic software updates are enabled.) You should run both anti-virus and anti-spyware software and check that the programs are kept up to date. In any world, software would be inherently safe against spyware and other threats. But that's not the world we live in, and it's one we are likely to see anytime soon. ■

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BY ROBERT KUTTNER

The 2% Solution To Fix Social Security

President George W. Bush's initiative to make Social Security partly private is in startling disarray. In recent days prominent Republican legislators have publicly distanced themselves from the Bush approach. A basic problem is that privatization is expensive, because it diverts payroll tax to a new system of private accounts. But any strategy of paying for it alienates

one key bloc of Republicans or another.

If you pay for the transition by borrowing an estimated \$2 trillion, fiscally prudent Republicans balk. If you cut benefits, as Bush aides have suggested, another batch of GOP legislators will resist. And if you raise taxes, as House Ways & Means Chairman Bill Thomas uncharacteristically proposed, still other Republicans desert. Virginia Representative Tom Davis, who heads the Republican Congressional Campaign Committee, has publicly declared that the whole thing is dubious politics, because it risks losing Republican House seats in 2006.

IN CONTRAST TO EVERY other major Bush initiative, few if any Democrats in Congress are willing to provide bipartisan cover. House Majority Leader Tom DeLay may have been too clever by half when he used the gerrymander to oust Representative Charles Stenholm of Texas, the leading (and perhaps only) Democratic supporter of privatization. In the Senate, where Montana's Max Baucus, the ranking Democrat on the Finance Committee, often gives Bush bipartisan backing, there are no Democrat defectors so far.

Bush's predicament is so serious that Republicans who normally loathe tax increases are suddenly talking about raising income subject to Social Security taxes in the hope of luring a few Democrats to support the Bush plan. But they have no takers. The White House nominally has the votes, since Republicans enjoy majorities in both houses of Congress. But without bipartisan cover for a vote that risks voter backlash, Republicans won't walk this plank.

Bush is also getting increasingly skeptical press coverage on his central contention—that the existing system is in dire crisis. Since 1997, the Social Security trustees (a majority of whom are now Bush appointees) have pushed back Social Security's supposed day of reckoning, when it won't be able to pay all its benefits, from 2029 to 2042. In other words, in seven years the system has gained 13 years of health, mainly because the economy has grown much faster than anticipated. And the Congressional Budget Office, with more realistic economic assumptions, puts the date at 2052.

So how will all this play out? Bush's idea of individual accounts is attractive. All Americans want nest eggs, and they

should have them, but not at the expense of Social Security, which is the one part of the retirement system absolutely guaranteed against market risks.

Fixing Social Security's actual shortfall, which is about 0.4% of gross domestic product over the next 75 years according to the CBO, is actually pretty easy. One politically risky way would be by raising the cap on the payroll tax from \$90,000 of income, to about \$140,000, as floated by the Senate and accepted in principle by Senator Lindsey Graham (S.C.) and Representative Jim McCrery (R-La.), who heads the House Social Security subcommittee.

The workers' share of the Social Security tax is 6.2% of wage and salary income. If we raise the cap, a person earning \$140,000 would see an increase of more than \$3,000 a year. It's hard to imagine either party proposing a major tax hike on the upper-middle class.

Restore the pre-Bush tax rate on the very richest U.S. taxpayers

There's a much better way. Roughly the same amount of revenue, about \$60 billion in current dollars, could be raised by restoring the pre-Bush income tax code on just the top 1% of taxpayers. Then, set up a system of universal, portable, supplemental pension accounts by restoring the pre-

income tax code on the second-wealthiest 1%. That would generate roughly an additional \$45 billion in current dollars. This money could be used as a government match, on a dollar-for-dollar scale, to encourage all Americans to set up private accounts. Remember, 98% of Americans would get no tax increase.

Each party would gain something. The Democrats could strengthen the existing system. The Republicans could get credit for setting up a system of universal individual accounts. Bush might not accept a bipartisan deal. But if he holds out for privatization financed by a raid on the existing Social Security system, he could well face his first big defeat.

Robert Kuttner is co-editor of The American Prospect and author of Everything for Sale.

JAMES C. COOPER & KATHLEEN MADIGAN

Signs that Inflation Is Losing Its Fangs

Global competition and the information revolution should keep prices down

U.S. ECONOMY As 2005 began, the economy faced the weakest start in more than seven years, oil prices near \$50 a barrel, and forecasts of slower productivity growth and rising unit labor costs. In the past, that combination—coming at a time of solid economic growth—was a recipe for serious inflation worries and strong policy

response. In fact, the latest consumer price report showed that inflation rose to 3.3% in 2004, up from 1.9% in 2003. That's a preview of further price acceleration this year? Probably not. As with so many trends in this business cycle, the past is no longer prologue. True, uncertainty in the Middle East, as evidenced by the clashes running up to Iraqi elections, clouds the outlook for oil prices. But fundamentally, the inflation process in the U.S. has changed dramatically in the last decade. First, the Federal Reserve has built up an unprecedented credibility in the financial markets as an inflation fighter. That faith has helped to keep inflation expectations low. Second, intense global competition continues to limit pricing power even with a weaker dollar and rising production costs. As a result, the corporate adjustment to higher costs tends to show up more in profit margins than in prices. Third, the technology-fueled speedup in the long-term rate of productivity means the labor-input cost of producing a unit of output now grows more slowly at any given rate of growth in wages and benefits. And finally, the information revolution is having one other, often overlooked, effect: It has empowered buyers by giving them more knowledge of products and markets, taking away some of the pricing edge that sellers used to hold. This new inflation dynamic creates important benefits for the economy. Price stability increases certainty, giving companies more confidence in the future and a greater ability to plan. In turn, certainty reduces volatility, a key reason why business cycles have become less severe. Finally, in an uncertain world, price stability gives investors and executives one less thing to worry about.

BOND MARKET seems to have taken notice. In the early part of an expansion, bond yields usually would rise significantly. But yields are no higher now than they were a year ago. Rates are back down despite last year's acceleration in economic growth, the runup in core inflation that excludes food and energy, and the five percentage-point hikes in interest rates taken by the Fed last June, with unanimous expectations for another percentage-point increase at the Feb. 1-2 meeting. These moves typically would have turned bond traders into panic-phobes.

Plus, in the past, nothing fueled inflation expectations more than rising actual inflation. But this time even that isn't true. Not only did oil lift overall inflation in 2004 but core inflation, which excludes energy and food, rose from 1.1% over 2003 to 2.2% during 2004. However, the measure of inflation expectations implied by the difference between the yield of a 10-year Treasury bond and that of a

10-year Treasury inflation-protected bond is only slightly higher now, at 2.4%, than it was at the start of 2004.

Undoubtedly, traders realize the exceptionally low rate of inflation in 2003 was an aberration, reflecting the lingering effects of the investment bust, the strong dollar, and a glut of global production capacity.

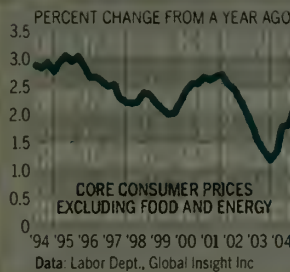
Prices of core consumer goods actually fell 2.5% in 2003, something that hadn't happened since the Great Depression. A bounceback was inevitable in 2004. But even so, core goods inflation in 2004 rallied to just 0.6%.

Total core inflation is back in the same range—about 2% to 3%—that it had been in from 1994 to 2002 (chart). And it will likely stay there in 2005. Plenty of slack remains in the labor markets and in industrial capacity. And solid U.S. demand will continue to attract cheap Asian imports, which so far have been unchecked by the dollar's decline against the euro and yen.

THOSE ARE CYCLICAL TRENDS, though. What's more critical to the inflation story is the way technology, productivity, and global competition have structurally transformed corporate pricing behavior. That's one reason Fed Chairman Alan Greenspan and other Fed officials remain optimistic about the inflation outlook.

That's true even with productivity growth slowing, as it usually does when an expansion gains traction. Slower productivity means that unit labor costs will grow faster this year than in 2004 (chart, page 26). In the past, that

INFLATION RISES, BUT FROM A VERY LOW LEVEL



has been an impetus for businesses to lift prices to maintain profit margins. Now, global competition has broken that trend. Greenspan noted in testimony last year that faster growth in unit labor costs will not threaten price stability if high profit margins come under more intense competitive pressures at home and from abroad.

As some Fed officials have come to believe, the degree to which rising unit labor costs are a short-run trend and not a structural change determines how businesses react. Companies know that a price hike risks a loss in market share, perhaps permanently. So for a short-run cost squeeze, it's a better strategy to shave margins a little instead of passing the costs along by raising prices.

For this year, the gain in unit costs will reflect the cyclical slowdown in productivity. Consequently, businesses should choose to absorb the rising costs in their profit margins rather than risk alienating customers.

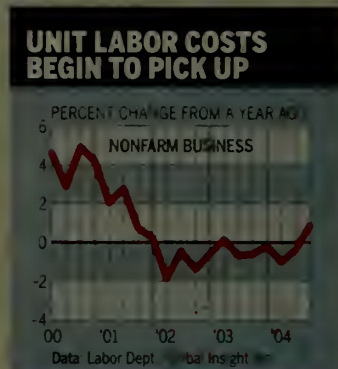
Oil is a prime example. Higher oil prices now have little, if any, lasting impact on inflation, because higher energy costs are less likely to lead to higher prices elsewhere. During last year's oil shock, businesses reacted by abruptly scaling back their hiring and inventory-building as they waited for the effects to play out. And bear in mind that if oil averages \$40 per barrel in 2005, as it did in 2004, the net contribution to the overall inflation rate will be zero.

IN ADDITION, INFLATION'S GRIP has eased because the information revolution has enabled price data to spread more quickly through the economy. As David Kelly,

economic adviser at Putnam Investments, has noted, information technology has leveled the playing field it comes to pricing.

Sellers used to have the upper hand in the marketplace: They had all the information—some proprietary—about costs, markups, and competitor

prices. Now that information is available on the Internet. But consumers can easily compare prices before purchasing a range of items, from airline tickets to mortgages. This access isn't limited to consumers. Players across the entire distribution chain, including commodity suppliers, manufactur-



wholesalers, and retailers, have it, too. "Information transactions is power," says Kelly. This bargaining power is another reason to expect inflation to remain low.

To be sure, plenty of folks are still concerned about the inflation outlook—and that group includes some in positions at the Fed. Part of that worry can be traced to the possible unintended consequences of the Fed's unusually liberal policy in recent years. However, given the evidence, it appears that inflation is one area in the economy truly has changed. ■

AUSTRALIA

Tie Me Dollar Bill Down, Sport

AUSTRALIA'S ECONOMY began the year with domestic demand losing momentum and a higher currency hurting exports.

The latest data on Australia's retail sales and foreign trade show the economy was slowing at the end of 2004. For the year as a whole, real gross domestic product probably grew by about 3.5%, down from a 4.3% rate in 2003.

Growth for 2005 is expected to ease to 3% or so. But will the slowdown quiet the recent inflation rumblings? Higher airfares and oil prices caused consumer prices to rise a larger-than-expected 0.8% in the fourth quarter from the third. For the year, inflation came in at 2.6%, near the

upper end of the Reserve Bank of Australia's target of 2% to 3%.

Inflation worries are also being stoked by tight labor markets. Almost 260,000 jobs were created in 2004, and the jobless rate in December hit a 28-year low of 5.1%. Although the surge in hiring has helped to lift consumer confidence to an 11-year high, it has not yet led to higher pay gains. The RBA will be watching to see if wage growth picks up this year.

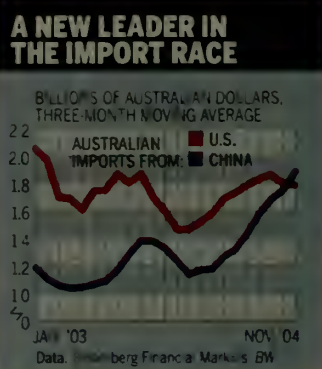
Inflation would probably be higher if not for the influx of imports, which have become cheaper thanks to the rise of the Australian dollar. It has surged 50% against its U.S. counterpart over the past three years. China, whose

currency is linked to the U.S. dollar, has been a big beneficiary. Imports from China are up 57% from year levels. China has overtaken the U.S. as Australia's No. 1 source of imports.

But the Aussie dollar has been a drag on exports, which account for one-fifth of the economy. Exports in both October and November fell. Imports rose to a record, resulting in a near-record trade deficit of A\$1.5 billion (\$2 billion) in November.

A year ago, the RBA's concern about the prospect of a housing bubble led it to raise its rate hikes of 2003 seem to have calmed that market. Building approvals slowed over the course of 2004, and the downturn was on.

For this year, the RBA will face a harder challenge. It will probably raise interest rates to slow inflation. But higher rates could push up the Aussie dollar even more, increasing the already big drag on the import-export sector. ■



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News Analysis & Commentary

RETRADING

YOUR NEW BANKER?

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Where are the women



-Mart can't be
own a full-fledged
bank—yet—but its
partnerships and
in-store financial
services are giving
the industry jitters

WAL-MART STORES INC. didn't get to be the world's biggest retailer by giving up easily. So despite being twice thwarted by lawmakers in its efforts to buy a bank, it has quietly but tenaciously expanded its foothold in financial services. In its latest move, announced on Jan. 21, the retailing giant is introducing a no-fee Wal-Mart Discover credit card that offers 1% cash back, which it will launch with GE Consumer Finance in March.

The retailing giant's relentless push into financial services is starting to send shivers through the banking industry. Few believe Wal-Mart will stop with basic services as it applies its low-price, high-volume formula to yet another business category. And while other companies, from Nordstrom to General Motors, have bank and thrift charters or hybrid Federal Deposit Insurance Corp.-insured industrial loan companies (ILCs) in tow, no one trips alarms like Wal-Mart. Many community bankers are convinced the behemoth won't rest until it has obtained full banking powers. "It's not a question of if Wal-Mart's going to be a bank, it's a question of when," says D. Anthony Plath, a finance professor at the University of North Carolina at Charlotte.

Clearly, Wal-Mart is on the move. Over the past three years, the giant has steadily built alliances with financial-service providers, such as MoneyGram International and SunTrust Banks, enabling it to offer services such as bargain-priced money orders and wire transfers. It has bank branches operated by partners in nearly 1,000 of its massive supercenters. And it has stepped up the pace. SunTrust is experimenting with nearly 45 in-store bank branches co-branded as "Wal-Mart Money Center by SunTrust," with plans to expand to about 100 of them by early 2006.

Already, Wal-Mart customers are reaping the benefit. They can cash payroll checks for just \$3, transfer money to Mexico for \$9.46, and buy a money order for 46¢. Some competitors charge twice as much. These are mostly high-margin, highly fragmented businesses in which the poor and immigrants are sometimes at the mercy of unscrupulous operators. "Traditionally, nonbank vendors of financial services have charged an arm and a leg," says David Robertson, publisher of *The Nilson Report*, a newsletter about credit and debit cards. Adds Gary Stibel of New England Consulting Group in Westport, Conn.: "Wal-Mart is giving people in lower-income brackets opportunities in financial services they never had before."

Financial services could open a rich new vein of profits for Wal-Mart as it seeks to remain a growth company. By one rival's estimate, the market for services that Wal-Mart already offers is worth about \$5 billion a year in fees, leaving plenty of room for it to slash prices while making a

AXEL KOESTER

profit. As it has with other goods, Wal-Mart will slowly "collapse the price umbrella," squeezing check cashers and wire-transfer leader Western Union Financial Services, predicts Robert G. Markey Jr., consultant Bain & Co.'s director for financial services.

For the time being, though, the basic services it offers represent little more than a rounding error for the \$287 billion goliath. Wal-Mart doesn't break out results for the unit, lumping them into the company's "other income," which totaled \$2.1 billion in the first three quarters of the last fiscal year. That was up 31% but amounted to just 1% of total revenues. Still, there's huge potential for growth. Says banking consultant Bert Ely of Ely & Co. in Alexandria, Va.: "They're developing, in customers' minds, a link between Wal-Mart and going to the bank. That has powerful long-term implications."

PERFECT FIT FOR UNDERDOGS

NOT ALL FINANCIAL-SERVICE suppliers are willing to ride this tiger. Jane J. Thompson, president of Wal-Mart Financial Services, concedes that "some of the leaders in the industry don't want to hurt their margins and don't want to work with us." But MoneyGram, with a market share of around 1% in global money transfers, is a distant No. 2 to Western Union, which has 12%. For such players, Wal-Mart promises huge volumes of business through its 3,100 U.S. stores and more than 100 million customer visits a week. As the underdog, MoneyGram was already cost-conscious and focused on growth, not on protecting margins—a perfect partner for Wal-Mart, says MoneyGram Vice-President Daniel J. O'Mal-



ley. And it can't hurt to learn how Wal-Mart does business, notes SunTrust Executive Vice-President Christopher T. Holmes, especially if Wal-Mart achieves full-fledged banking status.

Could Wal-Mart really become a bank? First it would have to take on current prohibitions on combining banking and commerce. The laws were designed to prevent a big player such as Wal-Mart from denying credit to competitors or shifting losses from its retail business to an insured bank. But many expect Wal-Mart to overcome those rules. Ronald K. Ence, vice-president of Independent Community Bankers of America, says Wal-Mart lobbied last year to expand the banklike powers of the ILCs. A bill that passed the House, but not the Senate, in 2004 would have allowed unlimited interstate banking, but only for those with at least 85% of their business in financial services.

Wal-Mart denies any such lobbying. It tried to buy a savings bank in Oklahoma

CO-BRANDING A Wal-Mart Money Center by SunTrust in Miss

in 1999, only to be blocked by the Gramm-Leach-Bliley Act, which overhauled federal banking law. And the California legislature blocked Wal-Mart's plan in 2000 to buy a small ILC.

Yet if Wal-Mart were to gain full banking status, it would be able to offer everything from checking and savings accounts to mortgages, car loans and even small-business loans at prices that rivals banks. It would be hard put to match the local grocery store and the local hardware store and the local clothing store, says the community bank group's Ence.

Wal-Mart insists its financial plans don't depend on owning a bank or a credit card. "Our strategy is to be where you see," says Wal-Mart's Thompson, who was once executive vice-president of Sears, Roebuck & Co.'s financial business. The services Wal-Mart offers are aimed squarely

at its core, lower-income customers and employees. Many are among the estimated 200 million Americans who either don't have a bank account or use few bank services. "Helping the underserved customer gets right at what Wal-Mart likes to be known for," says Thompson, who joined Wal-Mart in May. More important than the unit's profits, she says, is that these services bring customers into stores more often.

She seems to have learned from Sears's ill-fated effort in the 1980s

Coming in March: A no-fee, cash-back credit card

Banking for the Masses?

Wal-Mart has a track record of careful experimentation, followed by domination. Will it be able to do the same in financial services? It won't be easy.

REGULATION

Federal and state lawmakers shut down its efforts to buy an Oklahoma thrift and a California industrial loan company. And community bankers will put up a stiff fight to continue that separation of banking and commerce. They argue that Wal-Mart could drive small banks out of business nationwide.

BRANDING

Wal-Mart is famous for offering low-price goods of every sort. But as Sears learned in the 1980s, it isn't easy to sell mutual funds and insurance to the same folks who buy your socks and tires. Wal-Mart could make it hard for Wal-Mart to move beyond basic money services it now offers.

a financial supermarket with its insurance, Dean Witter brokered and Coldwell Banker Real Estate. Sears lost focus on its core business and found that many customers want to buy mutual funds or insurance from the same place that sold appliances. "My whole thing is starting with the customer," says Johnson, who joined Sears in 1988 and took over its credit operation

SMART BY BEING WARY

ALTHOUGH WAL-MART may be following a gradual approach to avoid mistakes, it occasionally hints at its ambitions. On its Web site, Wal-Mart describes itself as "a trusted name in financial services." In stores, it's slapdash powerful brand on the money operating in them.

Far bigger rivals say Wal-Mart isn't following them. 7-Eleven, which offers cashing, money orders, and the like with 1,000 electronic store kiosks, is focused on convenience, not offering the lowest price. Likewise, Eric C. Sington, a spokesman for Ace Cash Express Inc., the nation's biggest check-cashing chain, says Wal-Mart hasn't affected his company's pricing or growth. Wal-Mart has validated the importance of the market segment. That's attention it deserves," he says.

As toy retailers, grocers, and even banks have painfully discovered, competition in the face of Wal-Mart can be brutal. Given the giant's long interest in the financial arena, technological savvy, capital, and instant national reach, big and midsize banks, in particular, ought to be paranoid. Even big ones should be wary. "The mistake would be to bury your head in the sand and try to convince yourself that Wal-Mart is not a fact of life," says Bain's Markey. For no matter the obstacles, Wal-Mart seems determined to be a force in finance. ■

By Wendy Zellner in Fayetteville, Ark.

Work online For a Q&A with Jane Johnson, president of financial services at Wal-Mart, see www.businessweek.com/extras

PARTNERS

As with manufacturers, Wal-Mart gets low prices and high efficiency from its service partners. The huge potential Wal-Mart offer is attracting suppliers now, but Wal-Mart brings down prices. But will its reputation scare off other providers?

LABOR

Declaring War On Wal-Mart

Critics have had a field day with Wal-Mart stores Inc. in recent years, coining the term Wal-Martization to slam it for everything from alleged sex discrimination to poverty-level wages. The world's largest retailer finally got so fed up that it launched a 100-newspaper ad blitz in January to get out the message that "Wal-Mart is working for everyone."

Far from calming the critics, however, Wal-Mart's move has been more like blood in the water—particularly to organized labor, which is gearing up to launch what's likely to be its most ambitious effort ever against any company. The centerpiece: a massive national campaign to spotlight Wal-Mart's employment practices.

The aim isn't to unionize the retailer's 1.6 million workers, although that's still a long-term goal. Instead, the AFL-CIO intends to exploit Wal-Mart's image problems to drive away some business—enough, it hopes, to get the Bentonville (Ark.) company to alter its policies. "This will be an effort by the entire labor movement," vows AFL-CIO Secretary-Treasurer Richard L. Trumka. Wal-Mart spokesperson Sarah Clark denies that the company's low prices depend on low wages. "Evidently [labor leaders] feel they gain an advantage by making us look bad with a new publicity campaign," she says.

Labor's plans come as Wal-Mart is vulnerable on several fronts. The company's stock price has remained virtually flat for five years, due in part to Wall Street's disappointment at the retailer's single-digit same-store sales growth. And all the negative publicity has hurt Wal-Mart employees' morale. As a result, some shoppers now find them less friendly and courteous than they were in

the late '90s, says Chris Ohlinger, CEO of Service Industry Research Systems Inc., a market research firm that conducted a study on Wal-Mart customer attitudes. Says Wal-Mart Director of Investor Relations Pauline Tureman: "There are probably people who've made the decision not to shop at Wal-Mart because of the public criticism, but we can't quantify it."

Given this backdrop, unions could inflict

real pain. The AFL-CIO is planning an effort modeled on its powerful get-out-the-vote political machine. Headed by a veteran labor and Democratic politico, Ellen Moran, it aims to engage hundreds or even thousands of union members to do mailings, phone banks, and work-site visits to convince labor households and, later, the public, that Wal-Mart undercuts living standards. The campaign won't call for a boycott, but labor leaders say focus group studies they've done



show that some people may shop elsewhere if told of Wal-Mart's actions.

The campaign will be bolstered by a nonprofit umbrella group, the Center for Community & Corporate Ethics, founded late last year by the Service Employees International Union with \$1 million in seed money. Its goal: to coordinate Wal-Mart's disparate critics, from women's groups to environmentalists. "Wal-Mart hurts small merchants, destroys habitats, and increases profits at the expense of local communities," says Sierra Club Executive Director Carl Pope, a center board member.

Wal-Mart's low prices remain irresistible, especially to the working poor who labor aims to help. Even so, if all its critics gang up, the company could have its hands full protecting its image.

—By Aaron Bernstein in Washington

CONGRESS

SOCIAL SECURITY: IT'LL TAKE A HELLUVA SALES JOB

Pols of all stripes are more than shaky in their support for the President's reform proposal



IF SOWING THE SEEDS OF FREEDOM around the world was the keystone of President George W. Bush's sweeping Inaugural Address, a central focus of his Feb. 2 State of the Union message will be a subject much closer to home: an ambitious effort to "modernize" Social Security. But just as Bush's foreign policy vision met with skepticism abroad, his dream of a U.S. Ownership Society built on the bedrock of private retirement accounts is running into heavy opposition—from dug-in Democrats, the seniors lobby, social conservatives who would rather defend marriage than define benefits, and a growing chorus of worried congressional Republicans. Plenty of voters aren't convinced, either. In a Jan. 12-16 ABC/*Washington Post* poll, only 38% of those polled approved of the way Bush was handling Social Security.

Bush hopes to frame the drive to revamp Social Security as both an economic necessity and a moral imperative for future generations. And he'll hear plenty

of applause from the GOP side of the aisle. But the President knows that the political ground has been shifting out from under him on Social Security. As a result, the White House is scrambling to regain the initiative after a rocky kickoff to reform.

STICK TO HIS GUNS?

THE ADMINISTRATION has yet to put a specific plan on the table, although Bush promises more details in his upcoming speech to Congress. But already, Senate Republicans, many of them terrified of voting to reduce promised benefits for future retirees, are working feverishly to find Democrats willing to back a compromise. And, uncharacteristically, a stick-to-

Knock-Down, Drag-Out Fight

Bush's strategy to win the Social Security battle

SHORE UP REPUBLICANS He is set to meet with nervous congressional Republicans at a closed-door retreat. His goal: Persuade them to back a plan they fear could cost them reelection because of possible benefit cuts.

BIPARTISAN IMPERATIVE Key Hill Republicans are meeting with moderate Democrats to look for possible common ground. To date, Democrats have not given an inch.

HINTS OF FLEXIBILITY Bush had insisted he would not bargain specifics of his plan right away. But the White House has already been hinting that it might back away from deep cuts in promised benef-

ROCKY KICKOFF Bush knows the political ground is shifting from under

its-guns White House. He has already begun a more modest alteration to its initial agenda.

In a Jan. 26 press conference, Bush repeatedly offered to negotiate with Democrats. And, to top up his own wavering, he met with top GOP leaders on Jan. 25 and a pre-State of the Union meeting job was to culminate on Jan. 28, when Bush expected to make a personal pitch for his plan to rank-and-file congressional Republicans. "He has to be out of the room, or he's in deep trouble," says a Republican aide.

For their part, Democrats are shaping their own strategy. A hard-line moderates are talking to middle-of-the-road Republicans about possible compromises, although

the talks are going slowly. Says Sen. Lindsey O. Graham (R-S.C.): "The idea that in the next month we can establish a solid bipartisan beachhead." Bush has conceded, "in the early hours of the beach, we are being hit pretty hard."

Democrats reject the cornerstone of Bush's plan: allowing workers to opt out of a chunk of payroll taxes from the basic Social Security system to their own investment accounts. That would reduce the money available to pay benefits to current retirees and shrink promised basic benefits for future pensioners. Says former Congressional Budget Office Director Rudolph W. White, a longtime supporter of revamping Social Security: "Any notion of an in-

count financed by carving out pay-
 kes truly is a dead horse.”
 ead, some Democrats are push-
 r a plan known as an add-on ac-
 an idea first proposed by Bill
 n. These Democrats, such as for-
 linton aides Gene B. Sperling and
 R. Orszag, argue that Republicans
 a point when they say Americans
 ot saving enough for retirement.
 hey insist, private saving should
 outside of Social Security. So they
 l retool existing individual retire-
 accounts or 401(k) plans by mak-
 em more attractive to lower-in-
 workers. That could be done by
 g the current tax exclusion for an-
 ontributions into a credit, a setup
 enefits people in lower tax brack-
 ey are also talking up the ideas of
 ernment match for the contribu-
 of low-income workers and mak-
 orkers automatically enroll in the
 unless they take steps to opt out.
 aides and most Republicans say
 a proposal is a non-starter, but
 er and others think it could form
 isis of an eventual compromise.

TO IDEAS

ITS PART, the White House has
 hinting that it is also open to ne-
 ing over the other piece of the So-
 ecurity puzzle: how to close the
 etween the benefits government
 romised and the resources it has
 ble to pay them. Narrowing that
 ould require the painful steps of
 it cuts or tax increases—moves
 ost pols are unwilling to make. In
 January, Bush aides hinted he
 t change the way a retiree's initial
 l Security check is figured. Today,
 ear benefits are tied to increases in
 ge wages during a retiree's work-
 fe. In the new system, they would
 lked to changes in prices—a shift
 ould trim promised benefits by as
 as 40% by 2075. Now, after that
 was widely criticized, Administra-
 aides are hinting at a more modest
 ges that would skew reductions in
 e benefits to upper-income retirees.
 is early maneuvering is unlikely to
 in real horse-trading until Bush
 specific plan on the table. But the
 pectedly strong resistance to his call
 eeping change has sent a signal to
 White House: It must be willing to
 ow changes that fall short of the
 dent's ambitious goals or face a rare
 t on a signature initiative. ■

By Howard Gleckman and Richard
 S. Dunham in Washington

COMMENTARY

BY LORRAINE WOELLERT

A Phony Cure

Shifting class actions to federal courts is no reform

CORPORATE LAWYERS call them “judicial hell-
 holes.” The term refers
 to state courts, usually
 in rural areas, that have
 strong consumer-protection laws,
 antibusiness jurors, and judges
 who often have been elected with
 the help of the local plain-

tiffs’ bar. Sweeping class
 actions filed in these hos-
 tile jurisdictions have
 stung American Standard,
 Ford, Honeywell, MetLife,
 and many others.

But now, after years of
 lobbying, Corporate Amer-
 ica is about to get some re-
 lief. Congress appears to be
 on the verge of passing leg-
 islation that would shift
 most big class actions out
 of state court. Supporters
 of the Class Action Fair-
 ness Act (CAFA) argue that
 federal judges are better

equipped to handle such complex mat-
 ters. The legislation will be, in the words
 of Senate Majority Leader Bill Frist (R-
 Tenn.), “a big first step to restoring sanity
 and fairness to our legal system.”

Don’t believe it. While business is fully
 entitled to relief from judicial hellhole
 shakedowns, CAFA is more likely to be a
 step toward chaos rather than calm. At a
 time when federal courts are already
 overburdened, it will make case backlogs
 even longer. Indeed, some of the most ve-
 hement opponents of the proposal are the
 very same federal judges whom Frist and
 other tort reformers praise. In 2003 the
 U.S. Judicial Conference, a committee
 comprising federal judges across the po-
 litical spectrum, asked Congress to ensure
 “that federal courts are not unduly bur-
 dened and states’ jurisdiction over in-
 state class actions is left undisturbed.”

The new legislation flies in the face of
 that advice. It is, in essence, proof that
 tort reform does not necessarily equal leg-
 al reform. Engaging in half-baked poli-
 cymaking, lawmakers are tinkering with
 the rules just enough to claim credit with
 business lobbyists. But they’re falling far
 short of the coherent reforms necessary
 to fix the legal system’s real problems.

Even U.S. Supreme Court Chief Justice
 William H. Rehnquist has criticized
 CAFA’s approach. In a
 Jan. 1 annual report, he de-
 scribed the federal judicia-
 ry’s budgetary and staffing
 problems in sometimes
 alarming detail. Federal
 civil filings in 2004 rose
 11% even as budget woes
 forced a 6% reduction in
 federal court staffing. “As
 the Judiciary’s workload
 continues to grow,” Rehn-
 quist warned, “the current
 budget constraints are
 bound to affect the ability
 of the federal courts effi-
 ciently and effectively to



CRITIC Rehnquist says
 federal judges are too busy

dispense justice.”

And who has played the biggest role
 in creating the federal judiciary’s work-
 load crisis? Many of the same folks who
 support CAFA. Despite the pleas of
 Rehnquist and others, House and Senate
 Republicans have consistently refused to
 increase judicial budgets while denying
 requests for new judgeships to handle
 growing caseloads. And, ironically, some
 of the people who are voting to federalize
 big class actions are also the very ones
 who preach the loudest about the prima-
 cy of states’ rights.

This is not to deny that judicial hell-
 holes are a problem. They are, and CAFA
 has a lot to like. But any tort “reform”
 that calls for piling more work on the
 federal judges without giving them the
 ability to handle it barely deserves to be
 called a reform at all. ■

COMMENTARY

BY CATHERINE YANG

Getting Real at the FCC

Unlike Powell, the next chairman must put ideology aside to foster new service



POWELL The chairman is exiting in March

WHEN MICHAEL K. Powell exits as chairman of the Federal Communications Commission in March, his successor will face a world of dizzying technological change. Cell phones, digital TV, Wi-Fi hot spots, and music downloads are becoming the stuff of everyday life for many Americans. Meanwhile, the growing adoption of broadband is delivering ever-niftier services, from movie downloads to phone calls, over the Internet. The FCC will be navigating a world of real convergence between data, phone, and video services long predicted by futurists.

But as the agency wrestles with the issues raised by these dazzling developments, its new chairman must avoid the trap into which Powell fell: He came to hold an unshakable belief that technological advances would sweep aside the necessity for regulation. In the long run, Powell's dream may come true—and his deregulatory bent did boost competition. The Bells, for example, are building fast fiber networks to compete with cable carriers to bring Web, phone, and TV services to homes. Yet the market is still a long way from the competitive nirvana that

Powell envisioned. As a result, the chairman must safeguard basic communications services and promote new entrants who'll create competition.

While the White House isn't in its hand, Powell's likely successor appears to be FCC Commissioner Kevin Martin. He has shown that he understands the need for regulation: marketplace competition has yet to flower. He clashed with Powell—arguably lost—on local phone rules. Martin argued that local phone competition hadn't taken sufficient hold to warrant unshackling the Bells from requirements to lease their networks at a discount to local phone startups. But whether Martin or someone else, the next chairman will have a full plate. In four key areas spanning tomorrow's media, phone, and Internet services—consumers demand muscular action from regulators to

protect them as technology develops.

BIG MEDIA. Powell tried unsuccessfully to lift restrictions on the number of broadcast stations and newspapers one company can own. The advent of cable and the Web, he reasoned, created so many outlets that Old Media consolidation would reduce the diversity of viewpoints. But many of the most respected New Media outlets are owned by Old Media companies and may not offer the diversity he envisions. A federal appeals court overturned many of Powell's proposals. If the FCC loses a U.S. Supreme Court appeal and loses, the new chairman must be more measured to instill a free flow of ideas.

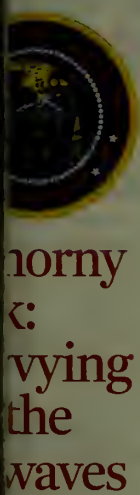
PHONES FOR EVERYONE. A century ago, AT&T and the Federal government established a subsidy system to ensure affordable telephone service to all, especially in hard-to-reach rural America. Today's universal service guarantees a communications lifeline for the urban and those in remote areas. But as more consumers abandon copper-wire networks to make their phone calls over the Internet, that system is eroding. Voice-over-Internet providers don't pay the universal service fee. Given the enduring consensus for universal service, the FCC needs to retrofit the program to ensure that all phone providers—wireless, Web, or traditional—that use the old phone network pay into the \$6.7 billion fund. Meanwhile, lawmakers and the FCC should examine whether that fund needs to be as more families have access to either wireless and Web phoning.

DIGITAL TV. Next, the FCC has to take on TV broadcast spectrum get back airwaves needed to expand wireless broadband

ack in 1996 lawmakers gave
asters a new part of the radio
um for digital transmissions.
asters were supposed to relin-
he airwaves they use for analog
when 85% of U.S. households
t digital TV—and no later than
by either measure, the deadline is
and wireless broadband innova-
clamoring for airspace in which
wireless services, such as WiMax.
roadcasters aren't about to give
ng back without kicking and
ing. The FCC, with help from
ess, should step in and take back
pectrum it's owed while finding a
migrate everyone to digital TV.

BAND RULES. Perhaps the
t challenge confronting the FCC is
d frontier of broadband service
ed by cable companies. The
ne Court will decide this year
er cable broadband access is sub-
regulation. However the high
decides, it will still be up to the
FCC to ensure
that cable compa-
nies don't dis-
criminate against
third-party serv-
ices that run over
their broadband
networks. Today,
for example, Von-
age Holdings
Corp. sells its
Web-phone serv-
ice using Time
Warner Cable's
broadband pipes.
But as Time
Warner and other
cable carriers
start selling their

Web-phone services, they must be
ed to route Vonage's phone calls
ciently as their own. Now, only the
DSL offerings are subject to such
ements. "If you're going to ad-
broadband to the greatest num-
Americans, you create an envi-
ent where competitive products
rive," says Dave Baker, vice-pres-
of law and public policy at At-
based Internet service provider
Link Inc., which would depend on
to cable high-speed and DSL net-
to survive in a broadband world.
The one day, a sufficient number of
technologies will compete vigorous-
ugh with one another that the FCC
free to step aside. But for now, the
tory hand is still needed to ensure
th transition to that future. ■



TRANSPORTATION

WHY GE IS KEEPING LOSER AIRLINES ALOFT

The bigger its customer base, the better. But over time, the industry may suffer

GENERAL ELECTRIC CO.'S aircraft engines may power the country's major airlines, but it's GE's money that is keeping many of them aloft. Since September 11, 2001, GE Commercial Finance and its aircraft leasing arm, GE Commercial Aviation Services, have sunk more than \$8 billion into global airlines, with a big chunk of that going to money-losers such as Delta Air Lines Inc. and United Airlines Inc. GE has also allowed feeble airlines to defer payments on leased aircraft, thus helping them keep more planes in the air and continue a price war on the ground. But while extending lifelines may be good for GE, it may be bad for the airline industry.

Airline executives roundly blame their losses on too much capacity, arguing that they can't boost airfares to cover their costs because there's always someone willing to offer bargain ticket prices. But

lately, whenever an airline seems as if it may actually go out of business and give surviving carriers some pricing leverage, GE steps in. The company recently offered new money that helped rescue bankrupt US Airways Group Inc. and FLYi Inc.'s struggling low-fare unit, Independence Air. Meantime, it helped to keep Delta out of bankruptcy with a \$630 million loan. Yet "leaving capacity in the hands of weak players is clearly detrimental to the industry," says one former airline CEO. With capacity now likely to grow rather than shrink, analysts predict airlines will lose some \$4 billion in 2005.

LIMITED DOWNSIDE

WHY IS GE SO eager to lend a hand? It makes money off the well-collateralized loans and wants to keep as wide a customer base as possible. The Fairfield (Conn.)-based giant owns about 1,300 aircraft, a massive aircraft-engine unit, and has more than \$29 billion in loans

Emergency Landing

General Electric has come to the rescue of almost every troubled airline, helping to save them from bankruptcy or outright liquidation

			
UNITED AIRLINES	DELTA AIR LINES	US AIRWAYS	INDEPENDENCE AIR
\$1.5 BILLION	\$630 MILLION	\$55.5 MILLION	\$19.5 MILLION
Loans and leases to parent UAL, mostly through secured lending	Loans in November, if Delta hits \$5 billion in cost cuts without bankruptcy	Loan and new lease terms in December, bringing GE's support to \$3 billion	Loan in early January and amended aircraft leases in return for debt restructuring

Data: Company reports

and leases to airlines. It's more exposed than rivals like International Lease Finance Corp., a unit of American International Group, which has 88% of its 676-plane fleet leased to airlines outside the U.S. But GE also demands so much collateral and places so many conditions on assistance that analysts believe its downside is limited. The loans to Delta, for example, are backed by \$3.5 billion in assets, ranging from spare parts to landing slots. "If GE were to take back a bunch of planes," says analyst Roger E. King of CreditSights Inc., "within a year they would have them all moved" to U.S. freight haulers or Asian carriers.

GE insists that it isn't getting in the way of industry dynamics. It has already taken back dozens of aircraft from its U.S. customers and has reduced its exposure to the large national carriers, says Henry A. Hubschman, president of GE Commercial Aviation Services (GECAS). "Each case is unique," he says. "We don't believe we are the ones who can strategically manipulate the market."

GE'S loans to Delta are offset by \$3.5 billion in assets

Even if one of the larger airlines were to fail, GE's hit would be minor. Hubschman says that the global market for aircraft is at its strongest since 2000. Only two of GE's planes are currently not on lease to customers. GECAS also saw its net earnings rise 13% in the fourth quarter, to \$167 million, though overall earnings for the year rose only 3%. To play it safe, GE set aside \$195 million in "aviation industry reserves" in the fourth quarter, primarily to offset anticipated losses related to US Airways. In his Jan. 21 teleconference with analysts and investors, GE Chief Executive Jeffrey R. Immelt said that with the move, "we are appropriately reflecting" where US Airways stands.

Of course, as US Airways executives point out, the death of any small or mid-dling carrier may not be a panacea when the rest could just add new planes. Many can count on help from GE, after all. Airlines may be entering their fifth consecutive year of losses, but for GE, the good times keep on rolling. ■

—By Diane Brady in New York, with Brian Grow in Atlanta, Lorraine Woellert in Washington and Wendy Zellner in Dallas

COMMENTARY

BY ANTHONY BIANCO

What Wriston Wrought

His innovations increased banking profits—and

WALTER B. Wriston, who died on Jan. 19 at age 85, was one of the three most influential American bankers of modern times. He ranks with J.P. Morgan, the omnipotent financier of the Gilded Age, and A.P. Giannini,

whose belief in the creditworthiness of the common man in the first few decades of the 1900s was the foundation of Bank of America. Wriston, who joined Citibank in 1946 and was its chief executive from 1967 to 1984, built it into America's biggest bank. More important, he was the pivotal figure in the transformation of the banking industry from a somnolent business straitjacketed by regulation into the global free-for-all it is today—a decidedly mixed blessing.

Wriston's Citibank helped free consumers from the tyranny of banker's hours by popularizing such innovations as the credit card and the automated teller machine on a massive scale. Under Wriston, Citi made enormous investments in computer technology while relentlessly chipping away at prohibitions that kept banks from paying variable rates on deposits or dealing in stocks, insurance, and other financial "products." Citi also became the first truly international U.S. bank, building branch networks in dozens of countries. "Others followed the same approach, but it was Walt who saw the way the in-

dustry was going to change and first to give voice to it," says John Wriston's successor.

Wriston's legacy is a banking industry that is incomparably more inventive, more profitable, but also far more ebullient-prone. "The stock market is what skeptical about the model," acknowledges Reed, who left Citi in 1987. "People worry—correctly, I think banks aren't as profitable as the nu-



TRAILBLAZER
At National City in 1974

say they are becoming all the charge end up taking. tendency towardly mishap was evident during ton's tenure, in the form of bad American loan Citi had reamassed in the and early 1987, Reed set \$3 billion—a equal to four profits—to cover

on Citi's Third World debt portfolio. In 1998, Reed fully realized Wriston's expansive vision by merging with Travelers Group, the second and insurance behemoth assembled by Sanford I. Weill, to form Citigroup. True to form, Citigroup today is as profitable beyond the wildest imaginings of the "stiff-collar" bankers. Wriston's youth and yet unnerve-susceptible to calamity. The company took \$5 billion in charges against earnings in 2004, shaving its net income to \$17 billion.

Walter Wriston joined the old National City Bank in 1946 for lack of a better alternative. "If I were to sit up at making a list of everything dull, banal would (have) come out on top," biographer Phillip L. Zweig. It's dull now, and that is more Wriston's doing than any one else's. ■



TAILING

FEDERATED IS BETTER OFF ON ITS OWN

Buying downmarket rival May could undo the gains Federated has made

SPECULATION HAS BEEN rife in recent weeks that Federated Department Stores Inc. is in discussions to acquire weakened rival May Department Stores Co. Neither company, respectively No. 1 and No. 2 in the department store world, will confirm that they're talking. But should the deal go through, it would create a retailing colossus with nearly 1,000 stores across the nation and \$30 billion in sales.

The question is: Would such a combination help Federated reclaim market share lost to specialty retailers? While buying May likely would boost Federated's earnings in the short run, it could undo the company's strategy of heading upmarket. At the same time, Federated could wind up sinking into May that it did better use itself. The end result," predicts Michael Hess, CEO of re-

searcher Merchant Forecast LLC, "will be further market share erosion for the combined Federated and May."

It's not as though buying May makes no sense at all. The department-store sector has been losing share for a decade. In theory, by acquiring May, Federated would gain heft, giving it more clout with suppliers, advertisers, and landlords.

But a May acquisition could potentially undo the gains Federated has made over the past few years. Since taking the helm in 2003, CEO Terry Lundgren has moved Federated aggressively upmarket.

Shopping For A Deal?

A Federated-May combo would face big challenges

- To boost May's fortunes, Federated likely would need to move it upmarket. But that would be tough since most May stores are located in moderate-income areas.
- In recent years, May has slashed costs. That doesn't leave Federated much room to boost efficiency. Plus, it might have to invest heavily to move May upmarket.
- A merger would likely boost Federated earnings near-term as it combines operations, but it wouldn't stem market-share losses unless Federated can improve sales.

MORE IN THE BAG

Unique, pricier goods have boosted sales

By offering more unique and higher-priced merchandise at its Macy's and Bloomingdale's Inc.

divisions, Federated managed to boost same-store sales 3.3% over the last 12 months. That's a whole lot better than the story at May, where same-store sales fell 1.6% in the same period. But it's nowhere close to recouping Federated's same-store sales decline over the previous three years.

UNFORTUNATE OVERLAP

ANALYSTS BELIEVE Federated would take May upmarket, too—likely converting its Kaufmann's, Filene's, Lord & Taylor, Marshall Field's, and Robinsons-May stores into Macy's. That's easier said than done. May has long catered to the mid-market. More than half of its stores are in the middle of the country, where not enough people can afford Macy's \$100 to \$200 designer denim to make an upmarket strategy fly. By contrast, most of Federated's stores are on the generally more affluent East and West Coasts.

Making matters worse, most of May's and Federated's overlapping stores are on the coasts. As a result, UBS Securities estimates that Federated could be forced to jettison nearly 100 of May's most productive stores. That would further crimp Federated's ability to take May upmarket. In addition, it could leave a potential opening for upscale retailer Nordstrom Inc. to move into those malls, giving Federated's best Macy's and Bloomingdale's stores stiffer competition.

Finally, while Federated could get the usual savings by cutting duplicate operations, it would be tough to wring out further efficiencies. That's because May already runs leaner than Federated, with sales and administrative expenses that run 29% of sales, vs. 31%. If anything, analysts believe May has cut expenses too much—particularly by slashing staff. As a result, says UBS analyst Linda Kristiansen, "Federated would likely have to invest more into May at the store level."

For all of these reasons, Federated might be better off flying solo—continuing to steal business from May while honing an upscale strategy to fend off specialty stores. Sometimes walking away from a deal is the smartest move. ■

—By Robert Berner
in Chicago



INSURANCE

A REMEDY FOR MALPRACTICE MALAISE

Hospitals are offering free coverage to recruit doctors from private practice

FOR THE PAST FEW YEARS, the insurance industry has been running Dr. Stephen W. Crane's practice into the ground. A perinatologist, Crane treats expectant moms who have complications that endanger their pregnancies. Malpractice insurance premiums for such high-risk specialists run as high as \$150,000 a year in Ohio—triple what Crane paid when he moved to Akron seven years ago from Syracuse, N.Y. And with many insurers dropping their malpractice coverage, Crane feared he would be ditched altogether. So when Akron Children's Hospital offered him a full-time job last December, he jumped, thanks to one tantalizing perk: The hospital would foot the entire bill for his malpractice coverage through its own in-house insurance company. "At some point, you can't afford to be in private practice anymore," Crane says.

Doctors and hospitals have been in a squeeze for some time, of course, as malpractice premiums have soared.

Now they're also getting inventive. To keep more physicians from bailing out, hospitals are increasingly offering doctors malpractice insurance through not-for-profit entities known as "captives." The captive at Akron Children's can cover Crane and his colleagues for 50% less than doctors pay on the open market, estimates CEO William H. Considine. That's because, unlike traditional insurers, hospitals don't have to calculate premiums based on industry-wide losses. Instead hospitals, which often supplement coverage through reinsurers, can design coverage around the hospital's track record, a much smaller risk pool.

Today only 7% of doctors actually work for hospitals; the majority just obtain privileges to practice at them. That could change rapidly as hospitals learn they can make an end run around insurers.

ALMOST BAILED
Crane's high-risk practice paid huge premiums

Among the 2 hospitals in 19 states," with the malpractice action is most ser

11% had in-house insurance in 2004 from 9% in 2002. That number is expected to multiply. "Interest is skyrocketing," says S. Allan Adelman, a partner with firm Adelman, Scheff & Smith LLC in Annapolis, Md., which advises hospitals setting up captives.

PRODUCTIVITY BONUSES

HIRING DOCTORS also gets hospitals around anti-kickback laws which prohibit hospitals from providing financial incentives to independent doctors who refer patients to those hospitals. Insurance could be construed as a kickback. But if you employ them, you can insure them, Adelman says.

The malpractice conundrum has emboldened hospitals to give the doctors another try. In the 1990s hospitals bought up physician practices, hoping to gain specialties that would make them more competitive. That was a disaster. Doctors resented hospital executives watching over them like Big Brother. For their part, the executives griped that doctors grew complacent. Now hospital CEOs are learning from those failures. For example, many hospitals are drawing up job contracts that allow doctors to receive bonuses based on productivity.

THE STAT

18%

Annual increase in doctors' malpractice insurance premiums*

*in 2003
Data: National Underwriter Data Services

Washington understands the bind doctors and hospitals are finding themselves in. President George W. Bush is pushing legislation that would cap so-called noneconomic damages for emotional distress—for instance—in malpractice cases at \$250,000. But experts doubt that reduced jury awards will motivate profit-driven insurers to lower their prices much. That's why hospitals are taking matters into their own hands. Akron Children's Considine says he plans to add three more perinatologists over the next 18 months. They'll join more than 50 pediatricians and other specialists he has hired. "We need physicians to be there for the kids," Considine says, "and we're going to be aggressive about employing them." With no end to the medical malpractice crisis in sight, he won't be alone. ■

—By Arlene Weintraub in New York

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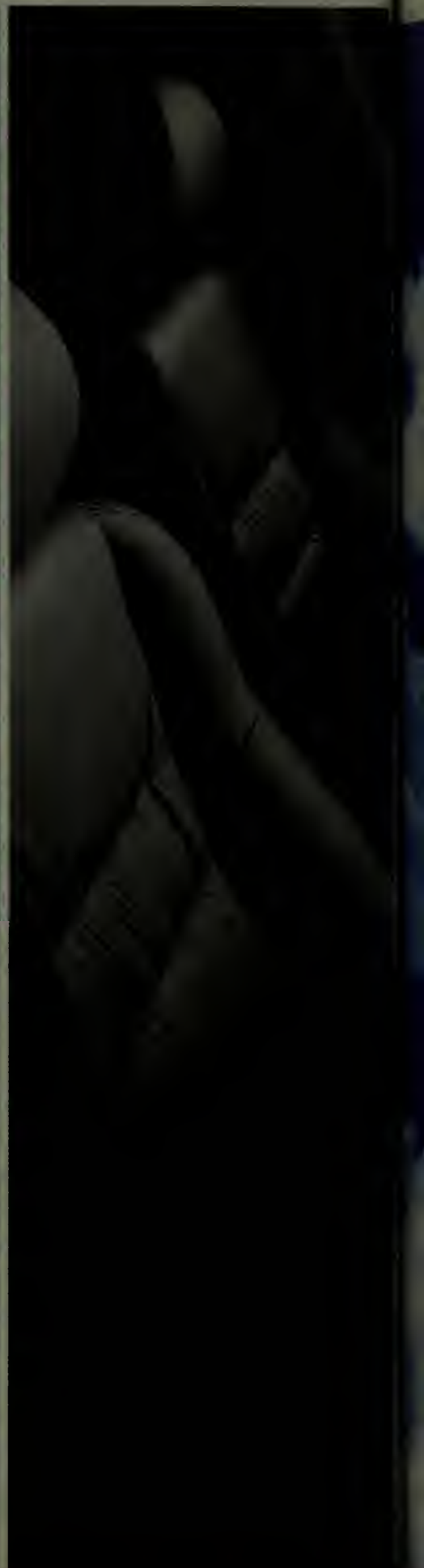
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COMMENTARY

BY CATHERINE ARNST

Getting Girls to the Lab Bench

To remain competitive, the U.S. must close the gender gap in science

LUCIE YUEQI GUO and Xianlin Li are proof that girls can love science, too. The two seniors at North Carolina School of Science & Mathematics, a high school in Durham, won the \$100,000 grand prize in the team category of the 2004-05 Siemens Westinghouse Competition in Math, Science, & Technology for a project studying the effect of DNA methylation on breast

cancer. (Got that?) "Both of us have been interested in science ever since we were very young," says Guo. "Neither of us ever felt our gender was a detriment."

Their perspective is welcome amid the furor over a now-notorious speech by Harvard University President Lawrence H. Summers. At a Jan. 14 conference on the paucity of women in the sciences, he suggested there may be "innate differences" between male and female brains that make it harder for women to excel in math and science. He quickly backed down. And in fact most scientists say there's little evidence that men's brains, though different structurally than women's, are better or worse at specific intellectual endeavors. "Intelligence is always the result of an interplay between biology and environment," says Rex E. Jung, a University of New Mexico neurologist.

The furor over Summers' comments obscures a critical issue: Women must be encouraged to enter engineering and science if the U.S. is to remain economically competitive. This is particularly true given that science and math abilities in the U.S. are badly lagging other nations for both girls and boys. "We can't afford not to encourage women," says Janie M. Fouke, dean of the College of Engineering at Michigan State University. "Half the brightest minds in the country aren't at the table."

How do we get them there? We can start by eliminating some wrongheaded assumptions. Throughout their early education and college, girls and boys show the same interest and aptitude for science and math. Women took home 47.1% of all the science and engineering undergraduate degrees awarded in the U.S. in 2000. Most of these were concentrated in the life sciences and chemistry, and women earned only about one-fifth of undergraduate engineering degrees that year. Still, it's pretty clear that women are interested in the sciences.

The gender gap really emerges when it comes time to apply



PEER PRESSURE
Science isn't perceived as being cool

that education. Far more men than women go on to get masters and PhDs in the sciences, and the National Science Foundation says industry employed only 994 women in science and engineering in 2000 compared with 3.1 million men. Universities are even worse. Engineering school faculties typically run 10 to 1 male.

Here's how we can start to change those ratios:

MENTORING. Shirley Ann Jackson, president of Rensselaer Polytechnic Institute, says youngsters need personal encouragement. "They need the involvement of their teachers, their groups, of people who can serve as role models." Guo and

Li, for example, say mentors were critical to their continued interest in science. "In the lab where we worked there were a lot of female scientists, they were all very inspirational," says Li.

HIRING. To get such role models, colleges must actively recruit women. That might be easier if science careers were seen as more family-friendly. It's more important to develop an atmosphere that's not hostile to women. Studies have found that science papers are judged more harshly if it is obvious the author was a woman. It's tough to overcome these cultural biases, but strong leaders from women like Susan Hockfield, the president of the Massachusetts Institute of Technology, is a start.

MAKE SCIENCE COOL. Truth is, boys are turning away from science as much as girls: The U.S. ranks below 13 other countries in the percentage of 24-year-olds with a math or science degree. "We have to change our culture to one that believes that it's really important to have a population that is well-educated in math and science," says Maria Klawe, dean of Princeton University's engineering school. If only that issue got as much attention as Summer's initial remarks. ■

Engineering school faculties typically run 10 to 1 male



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News In Biz This Week

EDITED BY MONICA GAGNIER

HEADLINER

DANIEL CARP



DIGITAL REMASTER

Eastman Kodak CEO **Daniel Carp**, who has been leading the photo giant's transition from film to digital, has an unwelcome distraction. On Jan. 26, Kodak said it would delay reporting final fourth-quarter results after discovering accounting errors. Kodak insisted that the problem stems from complex tax rules and does not involve misconduct. Even so, the company warned that when the matter is resolved, most likely within six weeks, aftertax income may be affected.

On a preliminary basis, Kodak reported a net loss of \$12 million for the quarter, on sales of \$3.8 billion, up 3%. But investors shrugged off the news, as Kodak shares closed virtually unchanged at \$31.66 on Jan. 26. That's largely because Carp is clearly making progress in his mission to transform the film giant. Digital revenues soared 40% in the fourth quarter, more than offsetting a 16% drop in its traditional film revenue. He predicted that in 2005, digital sales will exceed traditional sales for the first time.

—William C. Symonds

BIG PHARMA'S TAX HIT

Some major drug companies posted solid revenue growth in the fourth quarter—but saw their bottom lines hit hard by tax charges. **Johnson & Johnson**, **Eli Lilly**, and **Schering-Plough** all took big tax hits in the quarter because of plans to repatriate billions of dollars in profits that had been booked abroad. Johnson & Johnson still posted net income of \$1.2 billion for the quarter; Lilly and Schering recorded losses. While the move to bring back offshore earnings, made possible by the American Jobs Creation Act of 2004, dragged down fourth-quarter results, it could provide drugmakers with billions of dollars for research or acquisitions.

A NEW CHIEF FOR CORNING



Corning COO **Wendell Weeks**, 45, is taking the reins from **James Houghton**, who will retire as CEO for the second time on Apr. 28. Houghton came out of retirement in 2002 to save the company founded by his great-great-grandfather. After the telecom boom collapsed in 2001, many feared Corning wouldn't survive. But Houghton, who previously ran Corning from 1983 to 1996, managed to find huge new growth in ultrathin

glass for flat-panel TVs and computer monitors. With Corning back in the black, and the stock at \$11—up from just over \$1 in 2002—Houghton says “the time is right” for him to step aside as CEO, though he'll stay on as chairman. Weeks, who previously led the expansion of Corning's optical fiber business, has long been seen as Houghton's heir apparent (BW—Oct. 18).

PRICEY STREET REPAIRS

Goldman Sachs and **Morgan Stanley** each agreed to pay \$40 million to settle the Securities & Exchange Commission's charges that they pressed customers to buy shares after an initial public offering to pump up new stock prices. The settlement ends a lengthy SEC probe of abuses in the marketing of tech company IPOs in 1999 and 2000. The SEC alleged that Goldman and Morgan Stanley tried to induce customers to bid up stock prices in exchange for hot IPO allocations. Both firms settled the complaints without admitting or denying wrongdoing. The SEC is planning to issue new guidelines soon on IPO marketing practices.

NEW TRICKS IN NET SEARCHES

Four months after its debut, a tiny **Amazon.com** subsidiary has launched a big challenge to Web search leaders such as **Google** and **Yahoo!** On Jan. 27, **A9.com** announced a new kind of online Yellow Pages. It lets people not only find some 14 million local businesses in 10 U.S. cities but also view a series of photos showing the entire city block where the businesses are located, write

reviews, and call the businesses over the Net. It represents the most ambitious entry yet in local search. An attempt by search firms to take a bite out of the \$1.5 billion **Yellow Pages** market, **Amazon** isn't yet charging for the listings, making money far from sponsored ads provided by **Google**.

ET CETERA...

- » New products helped push **Hershey Foods'** fourth-quarter net profit up by 10%.
- » **Ford** said it expects to earn between \$530 million and \$745 million in the first quarter.
- » **EMC** raced past expectations with 46% increase in fourth-quarter earnings.

CLOSING BELLS

Somebody does like **Sara Lee**: investors. Shares of the conglomerate fell 9.5%, to \$22.50, in the two trading days ended Jan. 26, after it lowered its fiscal 2005 profit outlook. The Chicago company says it's facing a price war in Europe and higher commodity costs.





INSEAD

GROWTH VENTURES IN EMERGING MARKETS: SEIZING THE OPPORTUNITY

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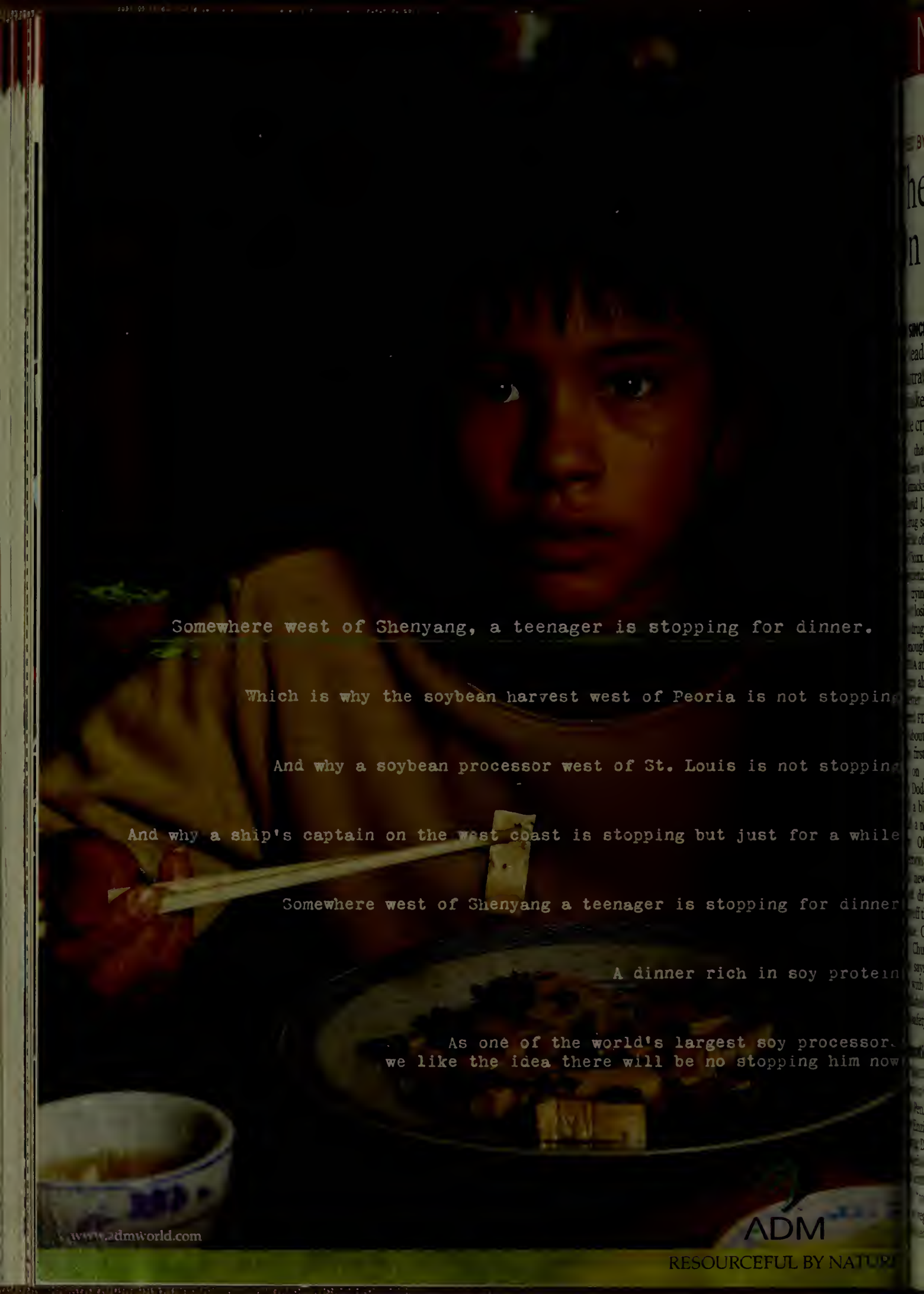
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A close-up, slightly blurred photograph of a young person with dark hair, looking directly at the camera while eating. They are holding chopsticks with their right hand, lifting a piece of food from a plate. The lighting is warm and somewhat dim, creating a candid, intimate feel. The background is dark and out of focus.

Somewhere west of Shenyang, a teenager is stopping for dinner.

Which is why the soybean harvest west of Peoria is not stopping.

And why a soybean processor west of St. Louis is not stopping.

And why a ship's captain on the west coast is stopping but just for a while.

Somewhere west of Shenyang a teenager is stopping for dinner.

A dinner rich in soy protein.

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we like the idea there will be no stopping him now.

EDITED BY MIKE MCNAMEE

The Vioxx Fallout on the Hill

SINCE NEWT GINGRICH & CO. seized control of Congress in 1994, its leaders have been putting the spurs to the Food & Drug Administration. The once-glacial agency has been pressured by drugmakers to approve new drugs faster and faster. Now, however, the cry of "full speed ahead" is being drowned out by revela-

that popular FDA-approved killers like Merck's Vioxx may cause heart attacks and strokes, and by charges by David J. Graham, one of the agency's drug safety officials, that the "FDA is unable of protecting America against another Vioxx." Lawmakers are talking about strengthening drug safety—and Big Pharma is trying to preserve quick approvals without losing more public confidence.

For drugmakers, the challenge is to find enough regulation. They don't want the FDA authority to order expensive trials of drugs already on the market. But with better monitoring of drug safety, the feared FDA could grow increasingly cautious about new medicines.

The first legislative salvo came on Jan. 21. Senator Christopher Dodd (D-Conn.) unveiled a bill that would establish a new \$100 million Center for Office of Patient Protection with power to demand new studies for approved drugs and to take them off the market. Senate Finance Committee Chairman Chuck Grassley (R-Iowa) says he will jump in with his own measure establishing an independent safety office.



TEAMING UP Kennedy and the GOP's Enzi will probe drug safety

Declaration of Independence?

DRUGMAKERS ARE paying special attention to the Senate Health, Education, Labor & Pensions Committee. GOP Chairman Mike Enzi of Wyoming is teaming up with fellow Democrat Edward M. Kennedy of Massachusetts to hold hearings—and perhaps introduce a bipartisan bill. Congress is "to determine whether changes in drug regulation are necessary to protect public health," says Enzi.

One problem, congressional investigators believe, is that FDA drug approvers also make the decisions about whether to withdraw drugs. In contrast, scientists like Graham, charged with assessing the safety of drugs already on the market, have little clout and resources. That's why there's so much talk about making the drug safety office independent. It will also help to have a permanent FDA chief, and one may be nominated soon. A top contender: Acting Commissioner Lester M. Crawford Jr.

But an independent office won't accomplish much without more funding. "We need new systems to monitor the use of drugs," explains Acting Deputy Commissioner Janet Woodcock. In a time of tight budgets, finding money for drug surveillance won't be easy. FDA officials hope that, when the bill requiring industry to pay "user fees" for drug reviews is renegotiated, drugmakers will add money for drug monitoring. "How can they refuse to pay more in light of Vioxx and David Graham?" asks one FDA official.

For industry, more expense could be the lesser of two evils. Stronger aftermarket reviews could boost public confidence in drugs—and might even help Big Pharma win caps from Congress on product-liability damages for FDA-approved drugs. The biggest concern, says James Greenwood, head of the Biotechnology Industry Organization, is that congressional action might have "unintended consequences that would slow down the approval process for drugs." That probably won't happen. But for the first time in a decade, Congress is paying more attention to drug safety than simply to speeding drugs to market. ■

—By John Carey

CAPITAL WRAPUP

MORE THAN ONE WAY TO SKIN A CARIBOU

FOR FOUR YEARS, Democrats have blocked President Bush's plan to drill in the Arctic National Wildlife Refuge. But Republicans may try an end run. How? By taking the controversial drilling provision out of long-delayed energy legislation and including it in the budget instead. Then the GOP could pass the ANWR provision with a simple majority, not the 60 votes needed to overcome a filibuster on nonbudget legislation. That would also make it easier to win passage of an energy bill.

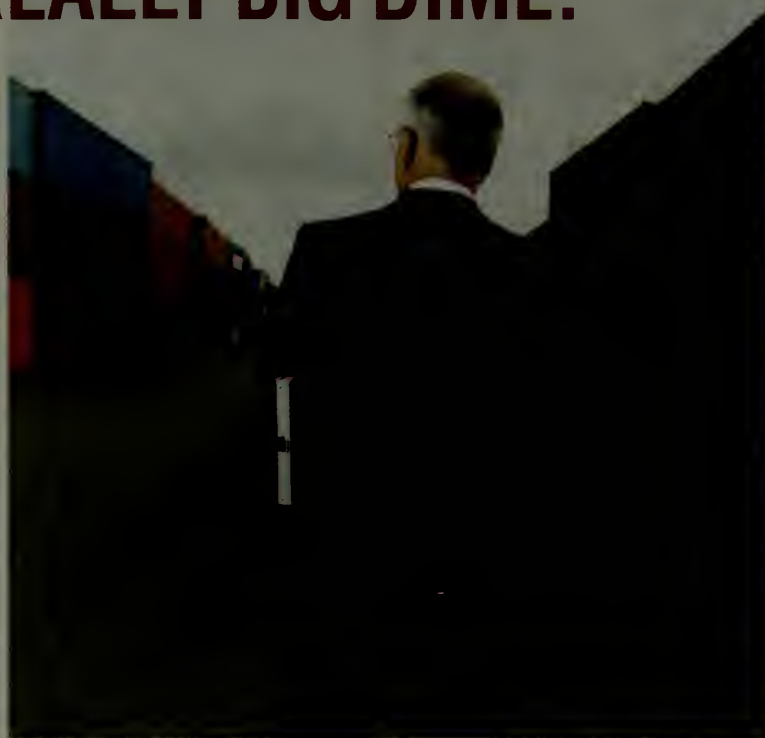
SEC OPENINGS: WILL DEMS HAVE A VOICE?

DEMOCRATS WORRY that Bush may replace both of the Securities & Exchange Commission's reform-minded Dems this year. Commissioner Harvey J. Goldschmid plans to return to the Columbia Law School faculty this summer. But fellow Dem Roel C. Campos wants to stay on when his term is up in August. Democratic leaders on the Hill want to keep Campos, too, but it isn't clear how much say they'll have. Corporate attorney John Olson and Texas Securities Commissioner Denise Voigt Crawford are viewed as possible White House replacements.

THE DRUG BENEFIT'S COST BALLOONS

A YEAR AGO, Washington was debating whether the new Medicare drug benefit would cost \$400 billion over 10 years or \$534 billion. Now the Congressional Budget Office says the tab will hit \$800 billion from 2006 to 2015. Why? The slow-starting program cost little in 2004-05—but will zoom past \$100 billion a year in 2013.

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IF IT’S A REALLY,
REALLY BIG DIME.”**





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ON DEMAND BUSINESS™

NETWORKING

WILL CISCO REWIRE ASIA?

It's poised to dominate broadband—but competition is heating up

BLISTERING SPEEDS, supercool applications, Internet telephony—nowhere in the world is broadband spreading as fast as in Asia. Stuff that once seemed like science fiction—wireless broadband connections quick enough to handle video downloads seamlessly, mobile phones boasting 30 channels of TV programming—is fast becoming reality in South Korea. India is launching broadband networks that have leapfrogged copper-wire phone lines and gone to Ethernet systems, akin to the ubiquitous networks found in corporate offices. How fast is digital Asia growing? Well, Chinese broadband penetration grew 99% last year. Fixed-line broadband connections in all of Asia soared 50% in 2004, to 62 million, according research firm Gartner Inc.

This is just the market Cisco Systems Inc., the colossus in networking equipment, loves. It wants the lead role in rewiring the whole region, as Asian telecoms deploy the cutting-edge networks that will drive communications in the next few decades. That should be easy: After all, Cisco dominates the region because it installed the first generation of Internet gear. Asia also could be crucial to reviving Cisco's stock, which has dropped 38% in the past year. Investors want to see double-digit top-line growth at Cisco without much slimming of its fat margins. Cisco's gross margins were

73% in Japan and 68.7% in all of Asia Pacific, vs. 67.6% in the U.S. in fiscal 2004.

Trouble is, Asia isn't just hot, it's hotly competitive. Huawei Technologies Co. is China's home-grown champ, and it won't give ground easily. Indeed, pricing wars may have already started. Cisco CEO John T. Chambers has said the company is already feeling margin pressure from Asian rivals, whom he expects will be Cisco's primary competition in coming years. In a recent earnings call, Chambers said Cisco is "starting to see a

THE STAT

86.7%

Cisco's share of high-end router market in Asia

Data: IDC Asia Pacific

stream of good—and very price-competitive—competitors, particularly from Asia. And we expect this to continue for the next decade." He must also contend with fast-rising Silicon Valley rival Juniper Networks Inc. and resurgent old-school telecom providers such as France's Alcatel. Says Adam Judd, Juniper regional vice-president for

Asia Pacific: "Every quarter we are making inroads on Cisco."

THE LONE PLAYER

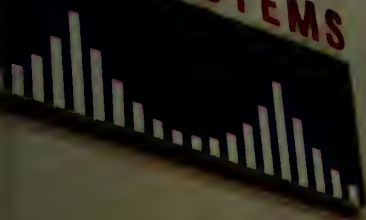
CISCO'S ASIA REVENUES are now \$3.68 billion, or some 17% of total sales, up 39% since 2000. It enjoys a 62% share for the Asian routers and switches that hustle data around office networks and the Internet, and an 86.7% share of the bigger routers typically bought by phone companies.

But Cisco developed that dominance largely because it was the only team in the league. Having invented the router back in 1984, the company had won near-monop-

BEIJING Cisco is battling with Huawei in China

olies by the time many Asian nations ed building Internet infrastructure in the 1990s. As big Asian customers choose for the next decade or two, however have other options. One recent example Industry sources say that while China com handed Cisco more than 40% massive contract late last year, Juniper a similar piece of the action. Cisco u

CISCO SYSTEMS



网络的力量

work—and that is what we are really about,” says Gordon Astles, president of Cisco’s Asia Pacific operations.

Cisco also plans to make the most of skills others can’t match, including its marketing might and its soup-to-nuts product portfolio. Rather than just sell individual boxes, the company offers consulting and software for a whole range of products, from security software to office phones. This, says Astles, is Cisco’s edge in the price wars. “The art of negotiation has been ingrained in Asian culture for over 5000 years,” he explains. “But the [client’s] primary concern is will it work, and will we be able to give customer service.”

Asians appreciate what Cisco can bring to the game. Park Kyung Chul, director of Internet planning at KT Corp., South Korea’s top telecom and largest broadband service provider, relies on Cisco for about 60% of KT’s routers, vs. 30% for

Juniper. “Cisco’s strength becomes obvious when they spot a problem,” says Park. “They are very good at resolving glitches in a speedy manner.” When a sudden data surge in the southern Korean city of Busan threatened to disrupt KT’s Internet service in 2003, Cisco sprang into action, quickly installing four-gigabite Ethernet modules that stabilized the traffic.

But even Park says Juniper is more creative when it comes to configuring ultrahigh-speed networks. Meanwhile, in Japan, Cisco

boasted about its December deal to sell one of its new high-capacity routers, the CRS-1, to Tokyo-based Softbank Corp. The router, which starts at \$450,000 and can handle 93 trillion bits (93 terabits) of data per second, will be used to bolster the backbone of Softbank’s Yahoo! BB, the biggest broadband player in Japan, with 4.6 million subscribers. Yet this is one of only a handful of

announced contracts for the CRS-1. While technically impressive, the machine is overkill for the corporate buyers that are Cisco’s bread and butter. Analysts question whether Cisco can quickly persuade phone companies to take a chance on its first router designed specifically to meet their need for no-downtime reliability.

Cisco faces its fiercest battle for supremacy in China. Its 57% market share in routers and switches is under serious attack from Huawei, which has 20.8% of the pie. “We can’t ignore a player with that kind of market share,” concedes Astles. There is no love lost between the companies. In 2003 the two settled a patent-infringement case Cisco brought against Huawei. Industry sources say Huawei will discount some of its gear up to 25%. And Huawei is getting ever more muscular. Samuel C. Wilson, an analyst with San Francisco-based JMP Securities

LLC, notes Huawei recently landed a \$10 billion credit line to fund its market-share assault and says that “many customers have been pleasantly surprised with Huawei’s products and commitment to win.” Huawei sales have grown 52% and 56% in the past two years, and at \$5 billion in revenues the compa-

ny is nearly 25% the size of Cisco.

Another way to deal with Huawei and other rivals is to win big in India, considered the next hot market. There, high-speed networks—wired and wireless—are expanding fast. The number of broadband subscribers jumped 236%, to about 500,000, in 2004—and Cisco has 75% of the business for routers and switches. Cisco is working with leading broadband provider Tata-VSNL to switch from copper-wire-based broadband networks to Ethernet and fiber networks that cost half as much to install, says Shashi Kalathil, chief operating officer of Tata Indicom Broad Band Services. Tata-VSNL’s broadband network, India’s largest, is scheduled to be completed in weeks. “With Cisco’s system, we’ve provided for 1 million lines, but it is easily scalable to 10 million, and that is critical for our business,” says Kalathil. The game is getting harder in Asia. But Cisco still has a good hand to play. ■

—By Brian Bremner in Hong Kong and Peter Burrows in San Mateo, Calif., with Moon Ihlwan in Seoul and Manjeet Kripalani in Bombay

In India, broadband is starting to expand at warp speed

in almost total lock on orders from the world’s largest phone company. Daunted, Cisco execs in Asia have plans to help design and equip next-generation networks that will deliver telephony service, video programming, and access over a new set of pipes that are fast, quick, and flexible. That requires intelligence running through the net-

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India and China: Oil-Patch Partners?

ONE OF ASIA'S MOST INTENSE RIVALRIES. With their fast-growing economies and soaring demand for energy, both India and China have been desperate to lock in long-term oil supplies in recent years. The oil majors of the two nations have spent billions bidding to invest in oil fields in places as far-flung as Angola, Burma,

Russia. "India and China are competing in the same sandbox. It creates a lot of tension," says Gal Luft, executive director of the Institute for the Analysis of Global Energy Policy in Washington.

Historic meeting

NOW THERE COULD be a new twist in intensifying competition. Indian Petroleum Minister Mani Shankar Aiyar wants to promote energy cooperation in Asia, including China. On Jan. 6 he hosted oil ministers from China, Japan, and South Korea—as well as eight OPEC producers—to discuss

forming a loosely named organization for Oil Importing Countries" to ensure stable, equitably priced energy supply for Asia. By lining up, Aiyar figures, China, India, South Korea, and Japan can cut a better deal from OPEC producers. He also wants to attract more investment. "It's a historic meeting that will influence geopolitical relations," says Ivo Bozon, Amsterdam-based chief of the oil and gas practice at McKinsey & Co. "If these [Asian] countries collaborate to influence the Arab nations on energy, they will be a formidable new energy bloc," adds Wenran Li, a political scientist who follows Asian energy at the University of Alberta in Edmonton, Canada.

Aiyar's oil diplomacy may reflect a broad rapprochement in India-China relations, which have long been strained by border disputes and Beijing's military backing of Pakistan. In recent years, India-China trade has enjoyed double-digit growth and is now valued at \$13 billion. On Jan. 24 officials from

both governments met in New Delhi to begin a strategic dialogue on issues ranging from terrorism to energy. And Chinese Premier Wen Jiabao plans to visit India in March. "It is the first time in five decades that New Delhi and Beijing find relations so cozy," says Zhu Feng, professor at Beijing University's School of International Studies.

Growing thirst

SOME ENERGY cooperation is already under way. China and India work together in Sudan, where China National Petroleum Corp. operates Sudan's Greater Nile oil field.



TEAM PLAYER
Aiyar is pushing for cooperation

India's Oil & Natural Gas Co. (ONGC) bought a 25% stake in the field in 2002. In Russia, ONGC is interested in a 20% stake in Yugansk, the unit of oil giant Yukos that was recently renationalized by state-owned Rosneft. China may lend Rosneft \$6 billion in exchange for a long-term oil contract. Aiyar would also like Chinese oil companies to invest in India and for pipelines to connect the countries. In addition, India is considering pipeline projects with countries such as Iran, Pakistan, Burma, and Bangladesh. "We need to build a truly Asian oil market," he says.

One way or another, Asia's oil thirst will grow. India imports more than 70% of its oil. China imports about 40%. That number could grow to 75% by 2025, the U.S. Energy Dept. estimates. China and India can compete for oil in a new version of the Great Game—or they can break the rules of power politics and step up cooperation. That would be startling indeed. ■

—By Manjeet Kripalani in Bombay,
with Dexter Roberts in Beijing and
Jason Bush in Moscow

GLOBAL WRAPUP

A NEW GOVERNMENT AT LAST IN UKRAINE

NEW UKRAINIAN President Viktor Yushchenko is moving to put his country on a reformist footing. In the two days following his Jan. 24 inauguration after a two-month power struggle, Yushchenko nominated his radical ally, businesswoman-turned-politician Yulia Tymoshenko, 44, as Prime Minister. And he asked the European Union to agree by 2007 to talks on Ukraine's desire for membership. EU officials favor improved ties but aren't putting membership talks on a fast track. Yushchenko has a three-year plan to get Ukraine in shape.

Early measures will be aimed at curbing bribery

Tymoshenko will be charged with implementing that plan if Parliament, as expected, approves her. An early measure will be pay hikes for the police, a bid to curb corruption. Tymoshenko aims to simplify the tax code to cut down on bribery and the black market, estimated at 50% of the economy. She wants to create a level playing field for investors by ending privileges that aided an elite close to outgoing President Leonid Kuchma.

Tymoshenko has a controversial past. In the 1990s, she made a fortune trading gas and was once briefly jailed on fraud charges, which she denied. She faces a challenge to ease tensions in divided Ukraine. Even so, Tomas Fiala, managing director of Kiev investment bank Dragon Capital predicts that, thanks to reforms, foreign direct investment will double to \$3 billion this year.

—By Roman Olearchyk in Kiev

The global counterfeit business is out of control, targeting everything from computer chips to life-saving medicines. It's so bad that even China may need to crack down. **BY FREDERIK BALFOUR**

FAK



Counterfeiters are now so proficient that forensic experts are sometimes needed to spot bogus products (pictured)



A year and a half ago, Pfizer Inc. got a disturbing call on its customer hotline. A woman who had been taking its cholesterol-lowering drug Lipitor complained that a new bottle of tablets tasted bitter. She sent the suspicious pills to the company, which tested them at a lab in Groton, Conn. The white oblong tablets

looked just like the real thing—and even contained some of the active ingredient in Lipitor. But soon determined that they were counterfeits. Over the two months, distributors yanked some 16.5 million

tablets from warehouses and pharmacy shelves nationwide.

An isolated case? Hardly. Last October, Brazilian police got a tip-off about a hoard of bogus Hewlett-Packard Co. inkjet cartridges and seized more than \$1 million worth of goods. Chinese police last year conducted raids confiscating everything from counterfeit Buick windshields to phony Viagra. In Guam, the Secret Service in July uncovered a network selling bogus North Korean-made pharmaceuticals, cigarettes, and \$100 bills. In June, French customs seized more than 11,000 fake parts for Nokia Corp. cell phones—batteries, covers, and more. In January, U.S. Commerce Secretary Donald Evans blasted the Chinese on a visit to Beijing, demanding they step up efforts to police intellec-

FES!



(L TO R) MARCUS THELEN; ROGER KENNY; DAVID G. MCINTYRE/BLACK STAR; ROGER KENNY; ED BETZ/AP/WIDE WORLD

COVER STORY

tual-property violations. Evans singled out the case of a General Motors Corp. subsidiary that is suing Chinese carmaker Chery Automotive for ripping off the design of its Chevrolet Spark minicar (page 70). The uncanny resemblance between the two cars, said Evans, "defies innocent explanation."

Critical Mass

KIWI SHOE POLISH, Callaway Golf clubs, Intel computer chips, Bosch power drills, BP oil. Pick any product from any well-known brand, and chances are there's a counterfeit version of it out there. Of course, as anyone who has combed the back alleys of Hong Kong, Rio, or Moscow knows, fakes have been around for decades. Only the greenest rube would actually believe that the \$20 Rolex watch on Silom Road in Bangkok or the \$30 Louis Vuitton bag on New York's Canal Street is genuine.

But counterfeiting has grown up—and that's scaring multinationals. "We've seen a massive increase in the last years, and there is a risk it will spiral out of control," says Anthony Simon, marketing chief of Unilever Bestfoods. "It's no longer a cottage industry." The World Customs Organization estimates counterfeiting accounts for 5% to 7% of global merchandise trade, equivalent to lost sales of as much as \$512 billion last year—though experts say this is only a guess. Seizures of fake goods by U.S. customs jumped by 46% last year as counterfeit goods boosted exports to Western markets. Unilever Group says knockoffs of its shampoos, soaps, and teas are growing by 30% annually. The World Health Organization says up to 10% of medicines worldwide are counterfeited—a deadly hazard that could be costing the pharmaceutical industry \$46 billion a year. Bogus parts add up to \$12 billion worldwide. "Counterfeiting has gone from a local nuisance to a global threat," says Hanns-Joachim DaimlerChrysler's point man on intellectual property.

THE GLOBAL COUNTERFEIT INDUSTRY...

A primer to one of the world's fastest-growing businesses

HOW BIG IS THE TRADE IN FAKE GOODS?

No one knows for sure, but the World Customs Organization estimates 7% of world merchandise trade, or \$512 billion in 2004, may be bogus products.

HOW QUICKLY IS THE INDUSTRY EXPANDING?

There's no sure way to tell. But one proxy is seizures of fake goods at borders. Last year, U.S. customs seizures rose 46%.

WHAT COUNTRIES ARE INVOLVED?

China accounts for nearly two-thirds of counterfeit goods. Other hot spots include the Philippines, Vietnam, Russia, Ukraine, Brazil, Pakistan, and Paraguay.

WHAT INDUSTRIES ARE AFFECTED?

Consumer electronics and luxury goods are knocked off most frequently, but so are auto parts, motorcycles, memory chips, cigarettes, shoes, medicine, and more.

JUST HOW PROFITABLE IS THE BUSINESS?

Counterfeiters can make a fake more cheaply than manufacturers can make legitimate products. And with no marketing, R&D, or advertising costs to defray, the profits can be huge.



LITTLE BLUE PROBLEM
Pfizer's Theriault holds real phony Via

e scale of the threat is prompting new efforts by multinationals to stop, or at least curb, the spread of counterfeits. Companies are deploying detectives around the globe in greater force ever, pressuring governments from Beijing to Brasilia to shut down, and trying everything from electronic tagging to reined products to aggressive pricing in order to thwart the counterfeiters. Even some Chinese companies, stung by fakes themselves, are getting into the act. "Once Chinese companies sue other Chinese companies, the situation will become balanced," says Stephen Vickers, chief executive of Internal Risk, a Hong Kong-based brand-protection consultant. China is key to any solution. Since the country is an economic gorilla, its counterfeiting is turning into quite the beast—accounting for nearly two-thirds of all the fake and piggyback goods worldwide. Daimler's Glatz figures phony Daimler—from fenders to engine blocks—have grabbed 30% of the market in China, Taiwan, and Korea. And Chinese counter-

feiters make millions of motorcycles a year, with knockoffs of Honda's workhorse CG125—selling for about \$300, or less than half the cost of a real Honda—especially popular. It's tales like this that prompt some trade hawks in the U.S. to call for a World Trade Organization action against China related to counterfeits and intellectual-property rights violations in general. Such pressure is beginning to have some effect. "The Chinese government is starting to take things more seriously because of the unprecedented uniform shouting coming from the U.S., Europe, and Japan," says Joseph Simone, a lawyer specializing in IPR issues at Baker & McKenzie in Hong Kong.

Yet slowing down the counterfeiters in China and elsewhere will take heroic efforts. That's because counterfeiting thrives on the whole process of globalization itself. Globalization, after all, is the spread of capital and knowhow to new markets, which in turn contribute low-cost labor to create the ideal export machine, manufacturing first the cheap stuff, then moving up the

value chain. That's the story of Southeast Asia. It's the story of China. Now it's the story of fakes. Counterfeiting packs all the punch of skilled labor, smart distribution, and product savvy without getting bogged down in costly details such as research and brand-building.

The result is a kind of global industry that is starting to rival the multinationals in speed, reach, and sophistication. Factories in China can copy a new model of golf club in less than a week, says Stu Herrington, who oversees brand protection for Callaway Golf Co. "The Chinese are extremely ingenious, inventive, and scientifically oriented, and they are becoming the world's manufacturer," he says. The company has found counterfeiters with three-dimensional design software and experience cranking out legitimate clubs for other brands, so "back-engineering a golf club is a piece of cake" for them, he says. And counterfeiters are skilled at duplicating holograms, "smart" chips, and other security devices intended to distinguish fakes from the genuine article. "We've had sophisticated technology that took years to develop knocked off in a matter of months," says Unilever marketing boss Simon.

The ambition of the counterfeiters just keeps growing. In China, recent raids have turned up everything from fake Sony PlayStation game controllers to Cisco Systems router interface cards. "If you can make it, they can fake it," says David Fernyhough, director of brand protection at investigation firm Hill & Associates Ltd. in Hong Kong. Don't believe him? Shanghai Mitsubishi Elevator Co. discovered a counterfeit elevator after a building owner asked the company for a maintenance contract. "It didn't look like our product," says Wang Chung Heng, a lawyer for Shanghai Mitsubishi. "And it stopped between floors."

Many fakes, though, are getting so good that even company execs say it takes a forensic scientist to distinguish them from the real McCoy. Armed with digital technology, counterfeiters can churn out perfect packaging—a key to duping unwitting distributors and retail customers. GM has come across fake air filters, brake pads,

THE STEPS TO FAKING IT

Steps of the trade are highly sophisticated

Capital comes from varied sources. Most businessmen invest in facilities for import or export. Local Chinese investors provide capital. Criminals invest as well. Sometimes multinationals that finance licensees support counterfeiters when the licensees make fakes on the side.

REUSE

Former employees of licensed manufacturers of branded goods can produce counterfeit products and reengineer licensed factories may add another plank out counterfeiters, using materials. Sophisticated equipment is acquired to give an appearance of authenticity. In the case of memory chips, discarded chip plants are smuggled to counterfeiters, who then etch brand names and logos into them.

CAUTION

An important step. Authorized manufacturers who decide to counterfeit can tap into distribution channels to enter retail outlets, restaurants, and more. Some counterfeiters mix fakes with real ones. Containers with fakes are deliberately shipped to many ports that it becomes difficult to determine their origin.



COUNTERFEIT LAB Unsterilized drugmaking equipment found in Taiwan



FAKE SMOKES A lab worker in Germany examines imitation Camel cigarettes

COVER STORY

and batteries. "We had to cut them apart or do chemical analysis to tell" they weren't real, says Alexander Theil, director of investigations at General Motors Asia Pacific. The parts might last half as long as the real thing, but that's not apparent until long after the sale.

The counterfeiters even ape the multinationals by diversifying their sourcing and manufacturing across borders. Last August, Philippine police raided a cigarette factory in Pampanga, two hours outside of Manila. What they found was a global operation in miniature. The factory was producing fake Davidoffs and Mild Sevens for export to Taiwan. The \$6 million plant boasted a state-of-the-art German cigarette-rolling machine capable of producing some 3 billion fake smokes, worth \$600 million, annually. The top-quality packaging came from a printer in Malaysia. The machinery itself was manned by 23 Chinese brought in by a Singapore-based syndicate, says Josef Gueta, director of Business Profiles Inc., a Manila firm that tracks counterfeit rings for multinationals. "They have shipping, warehousing, and the knowledge and network to move things around easily," he says.

As such counterfeiters get more entrenched and more global, they will be increasingly hard to eradicate. Financing comes from a variety of sources, including Middle East middlemen, local entrepreneurs, and organized crime. Sometimes the counterfeiters are fly-by-night operations, but just as often they're legitimate companies that have a dark side. In fact, many are licensed producers of brand-name goods that simply run an extra, unauthorized shift and sell out the back door. Or they are former licensees

who have kept the designs and go into business for themselves. Shoen New Balance Athletic Inc. is suing a for contract manufacturer in Guangdong province selling unauthorized Balance sneakers that turned up as far away as Australia and Europe. In the Philippines, semiconductor distributor Sardido Industries says it has been burned by counterfeiters that have sold it microprocessors rejected by inspectors from the likes of Intel and Advanced Micro Devices. These are done with logos and serial numbers to look like genuine parts and sold off cheaply as returns or production rejects. Other counterfeiters are generic manufacturers who moonlight as makers of fakes. Yamaha Corp. licensed five plants in China to make its motorcycles, but almost 50 factories actually produced bikes branded as Yamaha.

It's easy to find the counterfeiters, too. The Ziyi gang market in the sprawling city of Guangzhou, hours north of Hong Kong,

looks pretty much like any recently built Chinese shopping mall. But venture inside, and you'll find row upon row of shops offering bogus Gucci, Versace, Dunhill, Longines, and more. Each shop has just a few dozen samples but offers vast catalogs of goods that can be made and delivered in less than a week. At one outlet, a clerk offers counterfeit Louis Vuitton bags in various sizes. "Even fakes have many grades of quality, and the fakes are really, really good," she boasts. Exports? She's happy to arrange shipping to the country of your choice.

Once those goods leave China, they can sneak into the legitimate supply chain just about anywhere. Sometimes, phony components get used in authentic products. Last year, for example, Kyocera Corp., had to recall a million mobile phone batteries that turned out to be counterfeit, costing the company at least \$5 million. Unscrupulous wholesalers will find fakes on small auto-repair shops, office supply stores, or independent pharmacies by claiming they have bargain-priced—but not so obviously cheap—oil filters, printer cartridge bottles of shampoo that another retailer returned, or which are close to their sell-by date. Some traders mix phonies in with authentic goods. "It's easy to slide a stack of fake



POSEUR PARTS \$1 million in "Honda" spares get crushed in Manila

CALLAWAY GOLF CLUB

PROBLEM:

Fiberglass shaft rather than graphite; head made from steel rather than titanium

RESULT:

Shaft may break; head may rust; may cause golfers to slice or hook their shots



REAL: \$1,600*

FAKE: \$1,200*

*Price per set of irons

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CATALOG OF CRIME A Shanghai tout shows luxury fakes for sale in a store nearby

under the real ones," says one investigator based in Shanghai. "Most inspectors and buyers can't tell the difference."

Counterfeiters can also disguise their wares before they reach their final destination. Some ship unmarked counterfeit parts in several consignments to be assembled and labeled at their destination. And last May, Shanghai customs officials were inspecting a Dubai-bound shipment of 67 100cc motorcycles labeled with the brand name Honling. But when they peeled back stickers on the machines' crank cases, they found "Yamaha" engraved on the casting. "They are very sneaky and cunning, and that's very frustrating," laments Masayuki Hosokawa, chief representative of Yamaha Motor Co. in Beijing.

Strategic Defense

THEY ARE ALSO MAKING big bucks. Counterfeiting has become as profitable as trading illegal narcotics, and is a lot less risky. In most countries, convicted offenders get off with a slap on the wrist and a fine of a few thousand dollars. Counterfeiters, after all, don't have to cover research and development, marketing, and advertising costs, and most of the expense goes into making goods look convincing, not performing well. Fake Marlboros that cost just pennies a pack to make in China could end up selling for \$7.50 in Manhattan. Phony New Balance shoes can be stitched together for about \$8 a pair and retail for as much as \$80 in Australia, while real ones cost between \$11 and \$24 to make, and sell for up to \$120. Gross margins for knockoff printer cartridges are north of 60%. Counterfeiters "use low-paid employees and cut corners on safety," says Richard K. Willard, general counsel for Gillette Co., which turns up hundreds of thousands of imitation Duracell batteries every week. "If they can push them off as a high-quality product, there is a big margin for them."

While the counterfeiters are piling up profits, the multinationals are spending ever more on stopping them. Luxury house LVMH Moët Hennessey Louis Vuitton spent more than \$16 million

last year on investigations, busts, legal fees. GM has seven full-time sleuthing the globe, and Pfizer has 100 people working in Asia alone. Last September, Nokia started making bags with holographic images and 2D identification codes that can be authenticated online. Cigarette maker JT International has boosted its anti-counterfeit budget from \$200,000 to \$15 million in the past six years, spending the money on a network of investigators, lawyers, and informants in factories suspected of making fakes.

Pfizer will soon introduce radio-frequency ID tags on all Viagra sold in the U.S., which will enable it to track drugs the way from the laboratory to the retail medicine cabinet. Other companies strive to make life as difficult as possible for counterfeit manufacturers and distributors by changing factories and warehouses, or slightly altering the look of products to make it tough for counterfeiters

up with the changes. JT International—which sells Camel cigarettes outside the U.S.—sometimes digs through dumps at suspect factories looking for counterfeit packaging. Customs patrols the Web looking for suspiciously cheap clubs bearing a brand—though as soon as it shuts one dealer down, another is sure to pop up. "Getting rid of the problem altogether is much to ask," says Callaway's Herrington. "We just try to make the best and give the counterfeiters a really bad day."

One tactic is to outwit the counterfeiters in the marketplace. Anheuser-Busch Cos., for instance, was plagued by knockoff Budweiser in China. A big problem was that counterfeiters were refilling old Bud bottles, so the company started using expensive imported foil on the bottles that was very hard to replicate in China. The company also added a temperature-sensitive ink that turned red when cold. The result: "We've been able to keep [counterfeiting] at a pretty low level," says Stephen J. Budde, chief executive and president of Anheuser-Busch International. Yamaha, meanwhile, overhauled the way it manufactures designs motorcycles to lower costs. Now it charges \$725 for its cheapest bikes in China, down from about \$1,800. To stay competitive, counterfeiters have since lowered their prices to around \$1,000 to roughly half that.

The biggest challenge is getting cooperation from China. In the past years, Chinese authorities turned a blind eye to the problem largely because most of the harm was inflicted on foreign

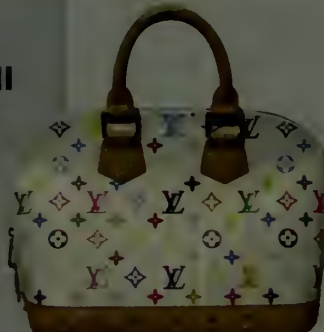
LOUIS VUITTON MURAKAMI HANDBAG

PROBLEM:

Cheaper leather, rivets, and fasteners; no lining

RESULT:

Wears out faster



REAL: \$1,200



FAKE: \$70

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THEY CAN RUN

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COVER STORY

owners and most counterfeiting was seen as a victimless offense. The only time China got tough on counterfeiters was when there was a clear danger to Chinese. Last year, for example, 15 infants died from phony milk powder. The ringleader was sentenced to eight years in prison. But when the victim is a company not an individual, the courts are far less severe. Last June, a Guangdong businessman was found guilty of producing fake windshields under 15 different brand names, including General Motors, DaimlerChrysler, and Mitsubishi Motors. He was fined just \$97,000 and given a suspended sentence. It's unclear just how much he made selling fakes, but GM gumshoe Theil says "there is no way the fine is commensurate with the profits he made."

But more Chinese corporate interests have seen profits hit because of counterfeiting—which may lead to a tougher response from Beijing. Li-Ning Co., China's No.1 homegrown athletic footwear and apparel company, has gotten the ultimate compliment from counterfeiters: They're faking its shoes. So today, Li-Ning has three full-time employees who track counterfeiters. The state tobacco monopoly is conducting joint raids with big inter-



HEAD TO TOE A display at a Shanghai anti-counterfeiting conference

national tobacco companies, since counterfeiters have started cranking out Double Happiness, Chunghwa, and other Chinese smokes. The crackdown, investigators believe, has forced some cigarette counterfeiters to decamp to Vietnam and Burma. And the government is finally realizing that piracy—which accounts for 92% of all software used in the mainland—isn't just setting back the likes of Microsoft Corp. "Piracy is a big problem for the development of the local software industry," says Victor Zhang, senior representative for China of the Business Software Alliance, an industry group. Some fear that Western companies may cut research spending in China if the mainland doesn't crack down.

Now, China is toughening its legal sanctions. In December, Beijing lowered the threshold for criminal prosecution of counterfeiters. Prior to the changes, an individual needed to have \$12,000 worth of goods on hand before police could prosecute. It was easy to skirt that rule by spreading the wares around. Today, that threshold stands at \$6,000 for counterfeiters caught with one brand and \$3,600 for those with two or more. And in late January, Beijing began the trial of two Americans who are accused of sell-

AC DELCO BRAKE PADS

PROBLEM: Inferior materials, less stringent quality control!

RESULT: Lasts less than half as long as the real thing



ing \$840,000 in knockoff CDs and DVDs made in China over the Internet. The two could face up to 15 years in jail if convicted.

One big problem: Too many scammers have ties to local officials, who see counterfeit operations as a major source of employment and pillars of the local economy. "Two or three raids have failed because of local protection," says Joe Tsang, chairman of Marksman Consultants Ltd., a Hong Kong-based company that has helped conduct raids on behalf of Titleist and Nike Golf. Take the example of a raid last August in Fujian province. The police found a dirt-covered hatchback in a stairway that led into a pitch-black cave. Inside was a recording machine, cigarette paper, and a die for stamping Marlboro Double Happiness packaging. But the counterfeiters had cleared out and taken the smokes with them. "We knew we were coming," sighs a Hong Kong-based investor who participated in the raid.

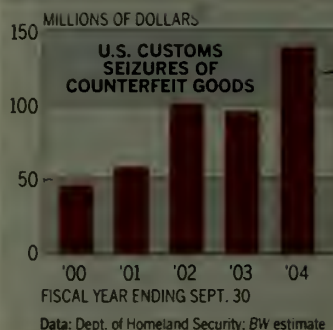
Embattled Beijing

BEIJING SAYS IT'S DOING what it can. The government has raised intellectual-property issues to the highest levels: Premier Zhu Rongji and Vice-Premier Wu Yi, for instance, has held regular meetings with the Quality Brands Protection Committee since 2003. "China customs is taking the fight seriously," says Yang Yang, director general for the Policy & Legal Affairs Dept. of the General Administration of Chinese Customs. The agency in November held a conference in Shanghai with brand owners and customs officers from around the world to map out strategy. But delegates acknowledged their biggest challenge is finding the funds to fight counterfeiting, as most governments are more concerned with preventing the smuggling of drugs and arms.

Could the U.S. apply stronger pressure to get China to crack down? "The answer is for the Administration to bring a case against the Chinese," says one leader of the intellectual property bar in Washington. The challenge is to secure evidence from U.S. companies, which desperately want relief but don't want to anger Beijing. More calls for a WTO action may come soon after the U.S. Trade Representative's office finishes a review of IPR in China in March.

Hard as it is, there's a reason to try to keep up the fight to stop counterfeiters. One is safety. Novartis counterfeiters have used yellow highway paint to get the right color match for fake painkillers. And in some African countries, counterfeit or illegal medicines account for as much as 40% of the drugs on the market. "You can't

GROWING MENACE



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have antibiotics without the ingredients," says Daniel L. Vasella, chairman of Novartis. Pfizer says police and regulators in Asia uncovered more than 1.5 million counterfeit doses of its hypertension drug Norvasc in 2003. "You are seeing counterfeiters exploit a loose supply chain and moving from lifestyle drugs to life-saving drugs," says Pfizer's vice-president for global security, John Theriault. "That should make people nervous."

The other reason to mount an offensive against the counterfeits is, obviously, the hit to corporate profits—and the likelihood developed markets will one day be seriously contaminated. It's already happening. In June, 2003, Tommy Hilfiger Corp. successfully sued Goody's Family Clothing Inc. for \$11 million for carrying fake shirts. The incidence of fake prescription drugs in the U.S., though small, is rising sharply. The U.S. Food & Drug Administration began 58 investigations of counterfeit drugs in its fiscal 2004, up from 22 in 2003.

More alarming, say police, is counterfeiting's connection to the underworld. "Organized crime thrives on counterfeiting," says Ronald K. Noble, Secretary General of Interpol. So does terrorism. Noble says profits from pirated CDs sold in Central

America have funded Hezbollah in the Middle East. On arette executive estimates North Korea earns \$100 million a year in fees from pirates producing there. That kind of ty, proves that buying fakes "isn't innocent, and it's game," says Bernard Arnault, chairman of luxury goods er LVMH.

The counterfeiting scourge, meanwhile, continues to s Pakistan and Russia are huge producers of fake pharmaceuticals, while in Italy an estimated 10% of all designer clothing is fake, much of it produced domestically. Gangs in Paraguay produce phony cosmetics, designer jeans, and toys from China. In the rest of South America, Bulgarians are masters at bootlegging U.S. liquor brands. This is one fight that will take years to win.

—With Carol Matlack in Paris, Amy Barrett in Philadelphia, Kerry Capell in London, Dexter Roberts in Beijing, Jonathan Wheatley in São Paulo, William C. Symonds in Boston, and Magnusson in Washington, and Diane Brady in New York

BusinessWeek online For a slide show and interviews on counterfeiting, go to www.businessweek.com/extras

DID SPARK SPARK A COPYCAT?

It's close to noon on a sunny January day, and the Chery dealership at the Asian Games Village car market in north Beijing is bustling. That's because the price of the popular Chery QQ minicar was just slashed by as much as \$725, to a highly affordable \$3,600. "The best thing is the low price," says one customer preparing to buy a gray QQ, which he says has "a fashionable shape."

General Motors Corp. execs would agree with that—which is why they're apoplectic. GM Daewoo Auto & Technology Co., the Korean subsidiary of GM, says the QQ is a knockoff of its own Matiz minicar, sold in China as the Chevrolet Spark since 2003. "The cars are more than similar," says Rob Leggat, vice-president for corporate affairs at GM Daewoo. "It really approaches being an exact copy." Same cute, snubby nose. Same bug-eyed headlights. Same rounded, high back. And most components in the QQ, Leggat says, can easily be interchanged with parts on the Spark. So on Dec. 16, GM Daewoo filed suit in a Shanghai court alleging that Chery Automobile Co. stole its trade secrets to make the QQ. Chery declined to comment.

This isn't the first time a foreign auto maker has felt ripped off in China. In 2003, Toyota Motor Corp. sued Hangzhou-based Geely Group Co. for copying the Japanese



CAR TROUBLE GM Daewoo is suing Chery, alleging the QQ (above) is a copy of the Spark



company's logo and slapping it on Geely models. Toyota lost the case. Yet Honda Motor Co. in December won a ruling that bars Chongqing Lifan

Industrial from selling motorcycles under the "Hongda" brand. Honda is also suing Shuanghuan Automobile Co., saying the Chinese company's Laibao SRV is a copy of the Honda CR-V sport-utility vehicle. "Chinese car companies still have limited [design] capabilities," says Jia Xinguang, an analyst at China National Automotive Industry Consulting & Developing Corp., a consultancy. "That is why so many [of them] copy bigger car companies' models."

Some, though, believe China needs to clean up its act on intellectual property if Chery and other auto makers hope to be successful overseas. "Intellectual property rights violations will be a major impediment to the aspirations" of Chinese car companies looking to export, says Charlene Barshefsky, former U.S. Trade Representative and now a Washington attorney.

Chery already has global ambitions. Last year the company exported 8,000 vehicles to Cuba, Malaysia, and elsewhere and started

assembling cars in Iran. In January, Chery announced plans to export five models ranging from a compact sedan to an SUV to the U.S. by 2007—though the QQ isn't part of the mix.

At home, the QQ is Chery's mainstay. The model made up 57% of the 87,000 cars it sold in China last year—outselling the Chevrolet Spark nearly five to one, according to researcher CSM Asia. And sales show no sign of slowing. In the first three weeks of January, the Asian Games dealership sold 118 QQs, says manager Zhang Ying, noting that the model costs about \$1,000 less than the Spark after the recent discount. With such a price gap, it's unlikely that the Spark will outsell the QQ anytime soon. So GM better hope it outmaneuvers Chery in coming years.

—By Dexter Roberts in Beijing

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A Wild Ride At NASCAR

How a "whiz kid" talked his way into owning a race team—and then hit a wall

ALEX MESHKIN'S STORY was so good it almost glowed. A precocious kid races through high school, graduating in three years. With his parents' blessing, he passes up college to become a day trader, quickly converting a tuition fund into a fortune. More money is made with a dot-com started up and sold in the boom years. Then on to NASCAR, where at 23, the boy wonder becomes the youngest team owner in major-league sports.

Meshkin has been telling versions of his Horatio Alger tale for years, and the media have been all ears. Profiles have appeared everywhere from *Wired* to *The Washington Post*. Last June the Fox Sports show *Totally NASCAR* called Meshkin the sport's "whiz kid."

It all sounds so sensational, so motivational. And it would be—if only the Meshkin story hung together.

But Meshkin, now 24, didn't graduate from a Maryland high school in three years, his day trading profits can't be confirmed, and he won't reveal the name of the outfit that he says "merged" with a Web site he co-founded in a deal worth \$24 million.

Now, Meshkin's racing business has a big hole in it, too. Besieged by angry investors and stung by sponsor defections, Meshkin's once-promising Bang! Racing is reeling. On Jan. 21 the team shuttered its 35,000-square-foot shop in Mooresville, N.C. In the garages in and around Charlotte, a hub of NASCAR racing, speculation is thick that the upstart team may not race in 2005—if ever.

In a 4½-hour on-the-record interview at a burger joint in Mooresville on Jan. 17, Meshkin told two *BusinessWeek* reporters that the string of publications that had written about him got his story wrong. He said his biggest mistake at Bang had been trusting in his team of NASCAR veterans.

That begs a number of questions: For starters, how did a whippersnapper with zero experience running a motor racing team elbow his way into NASCAR? How

did he persuade Toyota in just its first year of NASCAR racing to pick his bid for one of four sponsorships out of the 84 submitted? Did NASCAR conduct any due diligence on Bang Racing?

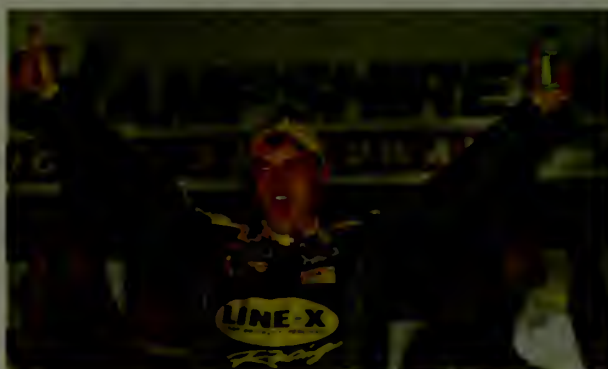
Just a year ago, NASCAR insiders were hailing Bang as a team to watch and Meshkin, its irrepressible owner, as a farsighted entrepreneur. His dream of melding the speed of NASCAR with cutting-edge technology impressed racing insiders and sponsors. It was only a matter of time, it seemed, before fans would be engaged in live chats with their favorite drivers at Nutzz.com, a Bang Web site. Or they would be reaching for their cell phones at the track for audio feeds from inside race cars. Both were among Meshkin's innovative ideas.

Those favorable first impressions have faded. Now, Meshkin finds himself at odds with many in the tight-knit racing community. His backers and fellow executives at Bang, who just months ago had soaring expectations for Meshkin, are his sharpest critics. In fact, as of

Jan. 26, a former Bang executive, attorney James L. Coffin, already hauled Meshkin into federal court, suing him for alleged misuse of Coffin's credit rating and for failing to live up to promises of a six-figure salary and equity in the team. Other refugees from the team are also threatening action. One is investor George Blacker, who says he put together \$400,000 in financing for Bang. Blacker claims that once Meshkin had the money in hand, he reneged on the offer and the size of a stake in parent company Bang! Inc. Meshkin says Coffin waited nine months after getting the money before starting legal action. He says Blacker misconstrued the terms of their arrangement.

Fox Sports analyst McReynolds, a former partner in Bang, just weeks ago he had never crossed paths with Alex. "Every morning I wake up hoping [Meshkin] goes back to where he came from," says McReynolds.

HOTSHOT
Travis Kvapil celebrates a big win

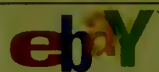


Gone But Not Deleted

Even when sponsors depart, Bang often keeps them on its Web site or is slow to remove them

LINE-X The maker of spray-on truckbed liners, Bang's second-biggest backer, has backed out*

TOYOTA Severed its relationship in late 2004 but was only belatedly taken off the sponsor list

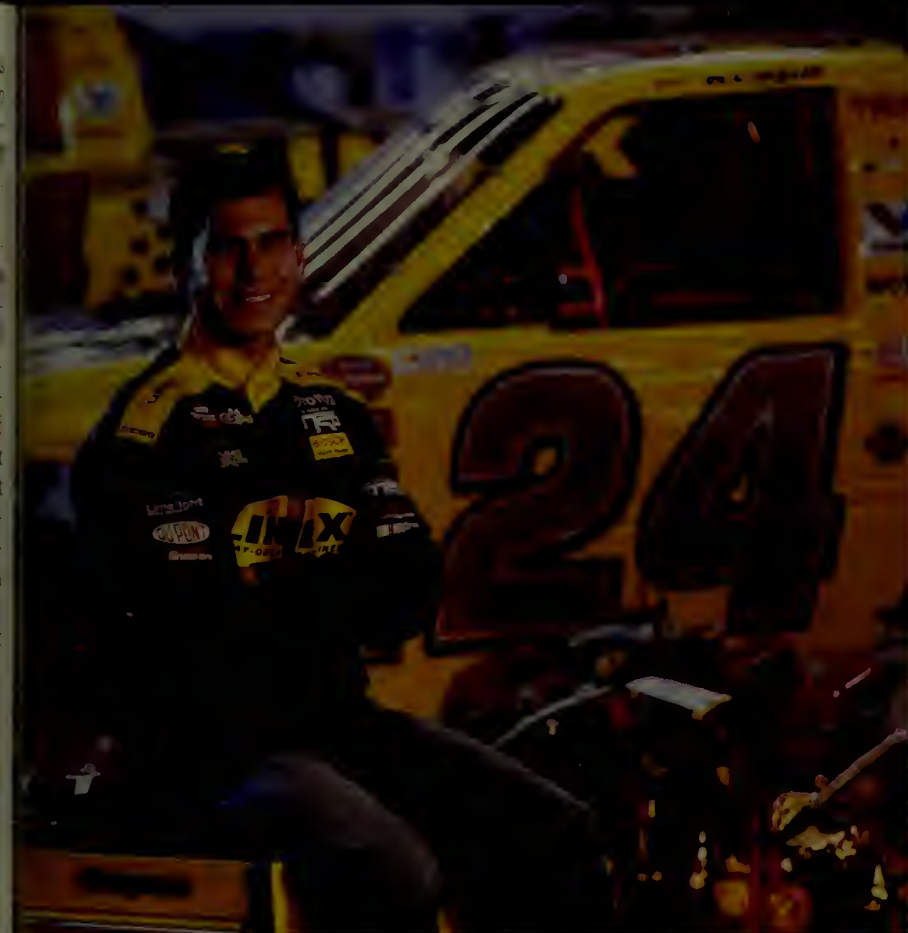


EBAY It withdrew as a sponsor at the end of last season*

DUPONT The chemical giant, a Bang sponsor in 2004, was no longer a backer in early January but was still on Bang's Web page



* Still listed as of Jan. 26



McReynolds, who was crew chief for the late Dale Earnhardt, is one of the most respected names in NASCAR. That he agreed to team up with Meshkin, a racing neophyte, says something about Meshkin's gift of persuasion. And McReynolds wasn't the only one to discover that Meshkin could talk the chrome off a hubcap. Just the others who believed that in helping to launch Bang, they were hooking up with a charismatic kid carrying a fat checkbook. The facts about Meshkin's personal life are fuzzy at best. Meshkin declines to provide any details about his current whereabouts. While still in high school in the late 1990s, he told *BusinessWeek*, he used his father's fund (with permission from his father) to become a wildly successful day trader. He said he cashed out of his day trading career with more than \$2 million. It was far from the last score, according to Meshkin. Even as the dot-com bust began, he says he and his older brother, Brian—from whom he is now estranged—sold Surfbuzz.com, a Web site that had started, for \$24 million in cash. Meshkin refuses to identify the buyer or explain clearly why he won't release that information.

Meshkin's track record in business—or at least his appearance of it—was enough to convince experienced sports executives that the aggressive team owner was the real deal.

"Everybody just assumed he was a very rich guy. I heard estimates of \$80 million to \$90 million," says Coffin, a former sports agent who says Meshkin hired him in September, 2003.

Meshkin's pitch also hit home with McReynolds, and he officially joined Bang as a partner in the fall of 2003. With McReynolds carrying the flag, Bang landed Toyota as lead sponsor of its Craftsman Truck Series team. Top drivers Travis Kvapil and Mike Skinner also joined Bang, as did an experienced crew chief, Rick Ren.

As the 2004 racing season progressed, Bang was living up to Meshkin's high expectations and racking up a strong record. But inside Bang, there was turmoil. To many at Bang, the team seemed chronically underfinanced. Meshkin doesn't dispute that money was tight, but he blames the spendthrift ways of McReynolds and others. "I thought the individuals advising me—Larry and a few others—would have an understanding of what things cost. They didn't," Meshkin says. To close the cash gap, Meshkin insists he put up his own money: "a couple of hundred thousand" in 2003 and more in 2004.

Coffin and other Bang executives complain that Meshkin fell behind on payments to them. Crew chief Rick Ren says McReynolds was fielding phone calls from

RIDING HIGH Meshkin during Bang's brief heyday

unpaid and irate suppliers. In his interview with *BusinessWeek*, Meshkin insisted that Bang paid its bills within 45 to 60 days, the norm in many industries. But Ren says that late payments became a sore point between Meshkin and McReynolds and spawned suspicions about whether Meshkin was a true tycoon. "These [suppliers] had all read the articles about how much money Alex had. And they wondered: 'If he has that much, how come he can't pay in a timely manner?'" says Ren.

PULLING OUT

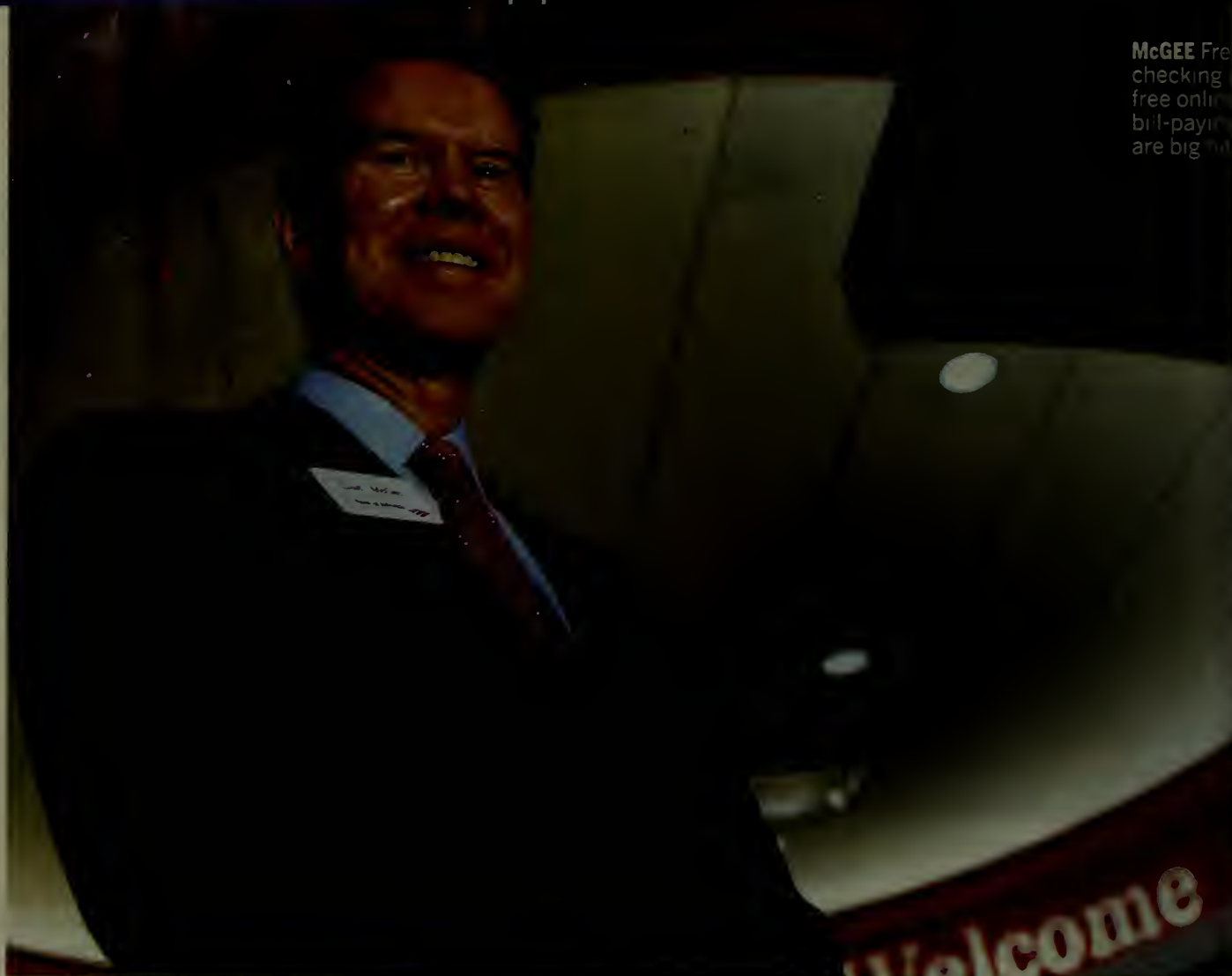
IN JULY, McReynolds announced he was leaving Bang. His departure was followed by another jarring blow. Toyota, which contributed 10 of Bang's 12 trucks and pumped \$6 million to \$8 million into the race team, according to a source inside the team, announced in August it was pulling its support—a highly unusual move so far into the season. "Our agreement specified that Alex and Larry McReynolds were going into this as partners. That was one of the key ingredients in our wanting to put together a contract with Bang Racing," says Les Unger, national motor sports manager for Toyota Motor Sales USA, of the decision to withdraw. Toyota was eventually nudged back to Bang by NASCAR CEO Brian France, according to sources close to Bang. A NASCAR spokesman, while not confirming that, acknowledged that France "was apprised of the situation." At the end of 2004, however, Toyota and Bang parted ways.

NASCAR declined to comment on any troubles at Bang. "If a team shows up at the track with a licensed driver and a race car that passes inspection, they can race," the NASCAR spokesman said. "The bottom line is we don't get involved in what happens within teams or race shops."

On Jan. 17, Meshkin was upbeat about the coming NASCAR season. His plan was to move up the NASCAR ladder to the Busch Series races with Kvapil driving Dodge cars. But on the morning of Jan. 21, according to a knowledgeable source, Meshkin gathered the remaining handful of Bang employees at a local Cracker Barrel restaurant and announced that he was shutting down the team.

Publicly, though, Alex is still the optimist. In a Jan. 26 e-mail to *BusinessWeek* from his BlackBerry, Meshkin wrote: "Bang will run in '05 we are restructuring which I can't explain yet do to [sic] business reasons. If you can give me until next week we can speak." ■

—By Mark Hyman in Mooresville, N.C., and Jordan Burke, with Mike France in Mooresville and John Cady in New York



McGEE Fre
checking
free online
bill-payin
are big

BofA's Happy Surprise

Consumer chief McGee's sweeping makeover of Fleet's branches is a success

IT'S A BLUSTERY THURSDAY morning, and Liam E. McGee is a man on a mission as he marches briskly into a Fleet Bank branch in Boston's historic district. McGee isn't here to cash a check. Rather, as president of Bank of America Corp.'s consumer and small-business division, he's making spot checks on some of the 1,500 branches the bank inherited when it bought

FleetBoston Financial Corp. last April. Striding through an eerily long corridor that winds back to the teller windows, the 50-year-old Irishman frowns as he navigates the quirky floor plan. "Layouts like this are just one of the challenges we have," he says. Finally inside the lobby, though, McGee is pleased to see the branch manager and reps engaging customers as they enter. "If you'd visited here

six months ago, you would have seen these people hidden back in their offices," he says.

So far, McGee's efforts to integrate FleetBoston's consumer businesses with Bank of America appear to be paying off—much to the surprise of Wall Street. The markets roundly panned the \$18-billion deal—one of the largest mergers ever—when it was unveiled in October, 2003. The concern was that BofA had grossly overpaid for FleetBoston, which had been notorious among customers for poor service and on Wall Street for lackluster financial performance. The deal was in part marred by a heavy exodus of Fleet executives as well as a spate of negative headlines after Boston politicians accused BofA of breaking its initial pledge that there would be no net job losses in England as a result of the merger.

But thanks in large part to McGee's sweeping makeover of Fleet's branch network, the deal is looking like a winner. After several years during which Fleet lost customers, Bank of America added 184,000 new consumer che

its and 196,000 savings accounts year in Fleet's old stomping grounds. BofA achieved that growth by wringing \$909 million in costs from FleetBoston, slightly more than it projected. The result: Fourth-quarter profits at the original Bank of America—the old FleetBoston grew 12%, to \$1.1 billion. Over the past year, BofA's profits have risen 16.9%, vs. a 6.3% rise for the Philadelphia KBW Bank Index. The Fleet deal "has gone far better than anticipated," says Steven Wharff, portfolio manager at Morgan Stanley Financial Services Trust, who owns 140,200 BofA shares.

G STAR

McGEE'S ROLE HAS NOT gone unnoticed. If he can maintain the heady performance of the consumer unit, some observers believe that he will be one of the favorites to succeed Bank of America's Chief Executive Kenneth D. Lewis. McGee, 57, is fully expected to remain in his job until he's 65. But BofA watchers expect Lewis to anoint a successor by the end of the decade. "[McGee] is the star right now," says one former executive.

Banking wasn't the first career choice for McGee, whose father worked as a Los Angeles bus driver after moving his family to Ireland when Liam was a child. McGee's initial brush with banking was a job as a teller during college. "The bank, I hated it—back then it was all paperwork, audits, and initialing checks," he recalls. But after earning a law degree from Loyola Marymount University, McGee rejected a career in law for a job as a lending officer for a small California bank. After stints at Wells Fargo & Bank of Security Pacific Corp., he eventually moved to oversee technology and operations for the old San Francisco-based FleetBank Corp.

After NationsBank Corp. in Charlotte, North Carolina, acquired BankAmerica—and changed the Bank of America name—McGee's star really began to rise. While McGee's executives from San Francisco bailed out, McGee bought into the deal. As head of BofA's Southern California operations, he was instrumental in rallying the old Fleet's demoralized workforce through whirlwind visits and region-specific voicemails. And the city councils of Los Angeles, Monica, Calif., and

San Francisco enacted ordinances to prohibit BofA from levying ATM surcharges on noncustomers, it was McGee who stepped in front of the TV cameras and helped turn public sentiment against the bans. The California courts ultimately ruled that they were unconstitutional. "More than any other individual, Liam turned it around for BofA in California," says one former BofA manager who worked closely with McGee at the time.

The key to BofA's unexpected success with FleetBoston, say analysts, has been the efforts of McGee and his team to overhaul Fleet's branches, from products to training to culture. To lure new customers, BofA dangled free checking and free online bill-paying, a service for which many New England banks still charged. And while the old FleetBoston simply gave customers the 800 number for an outside mortgage lender, BofA has outfitted roughly two-thirds of Fleet branches with special software that approves or rejects a customer's application for a mortgage or home-equity loans within 30 minutes.

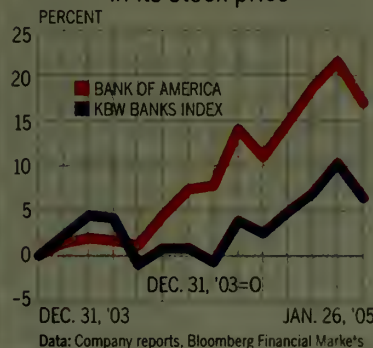
At the same time, Bank of America recruited dozens of new branch managers and reps from retailers with strong service cultures, such as Target Corp. It also adopted a few touches from Walt Disney Co. (Employees are now "on stage" when they're meeting with customers and "off stage" when they're in a back office handling paperwork.) And he implemented an exhaustive "playbook" that has scripts for everything down to the language with which tellers are supposed to greet customers. Still, at one Boston branch McGee visited, Paul J. Hillson, a consumer marketing manager, concedes that he encountered initial resistance from some FleetBoston tellers:

GROWTH MACHINE

Bank of America is attracting lots of new customers...



...and is enjoying a surge in its stock price



"What you hear is, 'But I already know that customer.'" McGee agrees that changing employee behavior "is still a work in progress."

Measuring each branch's performance and giving employees feedback are critical parts of the makeover. BofA brought in Six Sigma specialists to develop systems to generate reports on everything from customer satisfaction to sales productivity at each branch so that district managers can quickly intervene at underperforming offices. Already, each Fleet branch employee is signing up customers each day for an average of 4.1 new products, such as savings accounts and

credit cards. That figure has more than doubled since the merger, from 1.9, and McGee expects it to hit 6.4 this year. To prevent branch employees from indiscriminately flogging new products, BofA redesigned its pay plan to rescind bonuses paid for sales of any products that customers cancel within four months. "I don't want our associates just pounding product that customers really don't need," says McGee.

SOFTWARE SWITCH

McGEE ISN'T OUT OF the woods yet with FleetBoston. The biggest test comes this summer, when BofA switches Fleet's branches over to its own software platform—a process that, more than anything else, can lead to the service glitches that trigger customer defections. And some rivals contend that any gains BofA is making on the retail side are being partially offset by the defections of Fleet's old commercial-lending officers to other banks.

McGee acknowledges some loss of lending officers, but he denies that it has resulted in "anything close to a material nature" in lost loan volume. If that's the strongest criticism competitors can level, McGee has more than the luck of the Irish going for him. ■

—By Dean Foust in Boston, with Michael Eidam in Atlanta

BofA has nabbed nearly 400,000 new consumer accounts in ex-Fleet areas

Maybe Low-Key Is The Answer

Can the unassuming Brady Dougan spark change at unruly CSFB?

BRADY W. DOUGAN BEARS few of the outward signs of power on Wall Street. He doesn't wear flashy cuff links. He doesn't play golf. And he doesn't drink fine wines—just Diet Coke. Can this mild-mannered Midwesterner tame one of the Street's most unruly investment banks, Credit Suisse First Boston?

Seven months into the job, Dougan faces tough odds. His predecessors over the past 15 years have survived an average of only 2½ years, as executives at CSFB's parent, Credit Suisse Group in Zurich, often grew weary of the American offshoot's lackluster performance. The last, veteran, dealmaker John J. Mack, arrived from Morgan Stanley to much fanfare in 2001, and left last July.

After several years of restructuring, CSFB's 18,000 employees still racked up only about \$1 billion in profits last year, vs. \$1.3 billion at Bear, Stearns Cos., with 11,000 troops, and \$2.4 billion at Lehman Brothers Inc., with almost 20,000. Its share of lucrative merger advisory work has shrunk from 25% five years ago to 10% now, according to Thomson Financial. "Their record of the last five years has been so poor [that] it's become a much bigger mountain for them to climb," says Piers Brown, Commerzbank Securities bank analyst in London.

None of this deters the 45-year-old Dougan—Wall Street's youngest CEO and the only one with much overseas experience. Unlike past CEOs who strived to expand the firm's reach, Dougan aims to remake CSFB into a

nimbler, more specialized player. He wants to make CSFB as profitable as its rivals by building on its traditional strengths, such as overseas expertise and junk-bond financing. CSFB is the world's second-largest junk-bond issuer, with a 13% share of the business. Unlike rivals, he wants his bankers to focus on selling clients only what they ask for, instead of trying to be everything to everybody. And he wants them to work with their Swiss owners rather than fight them.

Dougan is facing his share of skeptics. Some say he started on the wrong foot in December by spinning off the firm's private-equity business and letting go one of its top junk-bond bankers. His new strategy of breaking down customers into groups based on which services they use—and how much business they provide—worries some clients who fear they'll get second-class treatment. And he's being forced to pay up to keep high-priced talent. In January, CSFB told its bankers that even though they didn't perform as well as their peers in 2004, they will get bonuses in line with the rest of Wall Street.

Still, Dougan is undaunted. He has set stiff financial goals, promising investors that he'll more than double earnings, to \$2.5 billion, by 2007. He has also vowed to almost double the pretax profit margin and return on equity over the same period, both to 20%.

THE STAT

150%

Targeted increase in profits by 2007

WHIZ KID
Dougan, 45, is the Street's youngest CEO

was raised in town, Murphy Ill., the young five siblings born

whiz kid, he took undergraduate college by day and business school coursework at night at the University of Chicago, working in the controller's office at bank. After earning his MBA at a Dougan joined the investment-bank division of Bankers Trust Corp. That led him to New York, London, and Tokyo, where he ran the bank's derivatives business at the age of 24. Dougan recruited him in 1990.

He got the top job last year in part because, unlike the commanding Mack, unassuming Dougan seemed unlikely to have a clash of egos with Credit Suisse Group CEO Oswald J. Grübel, 16 years senior. As head of equities in the 1990s, Dougan reported directly to Grübel, then chief of CSFB's securities division. And like Grübel, he was againing CSFB to another bank last summer. "No one thinks Brady is dressing for a sale," says Paul Calello, CSFB's of the Asia Pacific Region.



COMMENTARY

BY TIMOTHY J. MULLANEY

Finding Value on the Net

Smaller plays aren't as pricey as pundits think

But that doesn't mean Dougan isn't ratcheting up the pressure on CSFB managers. He's trying to rein in the firm's freewheeling culture, setting goals, and requiring managers to make frequent progress reports, sometimes weekly. "You can't talk to Brady for long without hearing the word 'accountable,'" says President Brian D. Finn.

Dougan believes his best chance at outmaneuvering his rivals is to use his, and CSFB's, overseas knowhow. In Europe, he aims to invest more resources in the exploding market for junk bonds and securitized commercial-building mortgages, already huge CSFB strengths. In developing countries such as Brazil, Russia, and China, Dougan is getting bankers and traders to focus on rapidly growing outfits that need more advice and assistance in issuing securities.

Dougan is also trying to rekindle CSFB's killer spirit on the trading floor. He is giving traders more capital so they can take greater risks—both for clients and for the firm's own account. And he is expanding the types of trades on the firm's own books to include not just bonds but also stocks and commodities such as oil. "We had been giving less money than the competitors because we were taking less risk," says Dougan. "We'll close the gap."

In his strategy to work, Dougan is getting the troops on his side. So he has been holding serial meetings with employees. He is asking for their ideas, improving the firm, attending seminars some evenings, and working long hours. Even so, some top managers and traders may opt to leave in January, after they get their bonuses. In a meeting with managing directors last week, Dougan will have his last shot to persuade people to stay. If they don't buy into his strategy, though, Dougan says he wants them to go.

Behind his desk, Dougan keeps a gift tag that says "Stick to the plan," reads one. "Stick to the plan," says another. The message: This most underdog of Wall Street chiefs is not about to give up. ■

Emily Thornton in New York, with Laura Cohn in London and Jonathan Wheatley in São Paulo

For investors in big-name Internet stocks, Jan. 19 was a painful day. When online auctioneer eBay Inc. blew an earnings report for the first time in 26 quarters as a public company, it didn't matter that the miss was by a mere penny a share. And it didn't matter that eBay earned nearly \$800 million last year. Web investors have always known that eventually they will have to stop paying 65 or 80 times earnings for Internet stocks as the companies get bigger and start growing more slowly. But as eBay shares bellyflop by \$20, to about \$83, investors started to wonder whether that time had now come.

So what's an investor, especially one with a nose for value, to do? The pros can't afford to skip the Big Four—eBay, Google, Amazon.com, and Yahoo!, which are members of indexes the pros are supposed to beat. But retail investors can hedge bets on the Big Four by buying smaller Net companies whose stocks are much more reasonably priced. In fact, most Internet stocks aren't nearly as expensive as armchair pundits think.

A look at these companies' prices compared with their estimated profit growth over the next five years makes them look even cheaper. Indeed, of the 20 blue-chip Web companies in *BusinessWeek's* BW Web 20 model portfolio, only six have PEG ratios—the price-earnings ratio divided by the expected annual profit growth of the company over five years—higher than the Standard & Poor's 500-stock index average.

Investors hunting for Web bargains should certainly look in Asia. E-travel agency Ctrip.com International Ltd. and online game producer Shanda Interactive Entertainment Ltd., both based in China, sport modest P-Es and PEGs low-

er than the U.S. market's. Shanda's PEG is 35% lower than the S&P 500's, even after third-quarter profits doubled. Online-media companies such as Sina Corp.—often called the Yahoo! of China—are cheap partly because of fears of government interference, but Sina costs half as much as the average S&P company on a PEG basis. With China's economy growing 9.5% last year, betting on Sina to boost profits half as fast as the S&P 500 doesn't seem nutty.

Investors should be especially comfortable with Ctrip, which caters to the burgeoning China travel market. Its business



PLENTY OF FRUIT

You don't need expensive stocks such as eBay, Yahoo!, and Google to get in on the Web's sizzling growth

NAME	PRICE*	P-E RATIO**
Digital River	\$39.45	25
Delivers software over the Net for customers such as Symantec		
aQuantive	9.48	34
Diversified online ad agency is a proxy for the growth in Web marketing		
Provide Commerce	33.99	42
Its Proflowers.com unit ships bouquets directly to customers		
Ctrip.com	39.73	32
Asia's top e-travel agency is still relatively cheap despite a big run		

*As of Jan. 26 **Based on forecast earnings for fiscal 2005
Data: Bloomberg Financial Markets, BusinessWeek, Piper Jaffray

model, focused on the more profitable hotel business instead of lower-margin airline tickets, closely resembles big U.S. winners Expedia Inc. and Hotels.com. If you had put \$1,000 each into Expedia and Hotels at their IPO prices, you would have walked away with about \$15,000 when they were acquired in 2003. With Piper Jaffray & Co. analyst Safa Rashtchy expecting Ctrip to earn \$1.25 a share this year, or \$19.6 million, up from 45¢ a share in 2003, a similar outcome for Ctrip isn't too much of a stretch.

Back in the U.S. there are low-cost companies in e-finance and online advertising. Even e-commerce plays have gotten less expensive as profits catch up to valuations. CheckFree Corp., which makes software that banks use to provide online bill-payment facilities to customers, has the same PEG as the S&P 500. Online ad agency aQuantive Inc. is picking up a following. Its range of services—from creating banner ads to tracking the performance of search keywords—is more diversified than most of its rivals. And its P-E of 32, combined with projected 25% annual profit growth, produces a below-market PEG.

One of the hottest second-tier Net stocks has been Provide Commerce Inc., whose ProFlowers.com is stealing market share from 1-800-Flowers.com. By shipping flowers directly from growers, it cuts out local florists and distributors. It says its flowers are cheaper, even with shipping—and up to a week fresher. The shares are up 90% since August, yet they're still less pricey, on a PEG basis, than the market.

Most fund managers and analysts still place their biggest Net bets on Google, eBay, and Yahoo. And even their valuations have come down: Google is at about 50 times S&P's 2005 earnings estimate. eBay's P-E is 53, down from 65 to 80 in recent years, and its PEG is almost the same as the market's. Amazon.com's is around 42. History says to stick with them: Among the BW Web 20, the best performers since 2002 have been well-known companies with high-multiple stocks. But they can't be retail-investors-only Web bets—and don't have to be.

What investors can count on is that the \$144 billion U.S. e-commerce market will keep growing exponentially. And a market that's getting so big so fast will generate good investments—some of which you've never heard of. ■

BusinessWeek online To see the full BW Web 20 portfolio, please visit us online at www.businessweek.com/extras

UPBEAT CEO
We're "in the sweet spot of where health care is moving"



Breathing Life Into HealthSouth

Jay Grinney isn't letting accounting ills, investor suits, or business woes faze him

HEALTHSOUTH CORP., the once-prominent company laid low by the alleged crimes of its flamboyant founder, Richard M. Scrushy, is one of those places a certain kind of ambitious would-be chief executive gets excited about. In the past 30 months, a key bondholder threatened to push it into bankruptcy. The company was charged with Medicare fraud, investigated by the Securities & Exchange Commission, and sued by investors. Its accounting was a shambles. Oh, and the nationwide chain of rehabilitation and surgical facilities continued to rely on Medicare for 45% of its revenues, even as new guidelines that would cut into its business were enacted.

What's not to love about a job that?

That's how Jay Grinney, a 53-year-old former HCA Inc. executive who took over last May, feels, anyway. But there's also the kind of person who chooses to work part-time shoveling out penicillin turkey farm while his classmates at Olaf College in Northfield, Minn., are in the library. "I just like to do things other people don't want to touch," he says with a grin.

Of course, Grinney also can't ignore HealthSouth with the conviction that he could stave off doom, the \$3.8 billion company would be at the nexus of powerful trends: the aging of the boomers—which should create demand for the physical therapy and rehab services that HealthSouth of

l the overall push by Medicare and IOs to move patients out of traditional hospitals and into the kind of lower-cost specialty centers that HealthSouth operates. And while HealthSouth was where near as profitable as it appeared under Scrushy, whose trial on 58 criminal charges connected to the alleged accounting fraud began on Jan. 25, the company was still generating some \$100 million in cash flow amid all the turmoil. "I really believed that if we could deal with all of these rocks in the pond, this company was sitting in the sweet spot of where health care is moving," Grinney says.

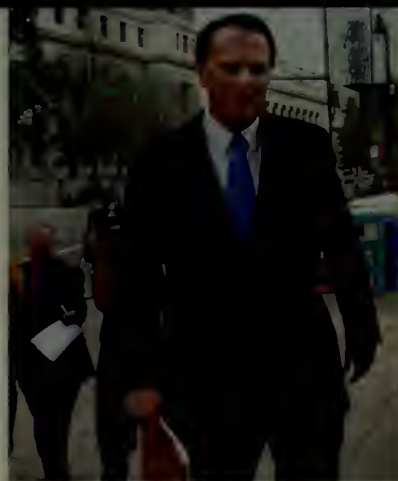
DEATH WATCH

THE REASON HE'S so sure is that he had worked for years as an administrator in hospitals, the same institutions from which HealthSouth was taking business. After earning an MBA and a master's degree in health administration from Washington University in St. Louis in 1981, Grinney joined Houston's Methodist Hospital as a management trainee. Nine years later, he jumped to Columbia Healthcare Corp.; soon he was in charge of two dozen hospitals and had developed a reputation as a meticulous administrator and tough negotiator. When talks with a Houston hospital that Columbia was hoping to acquire broke down, Grinney bought land next door to

build a competing facility in its shadow. "Jay always has a Plan B," notes Mike Snow, a former HCA executive who is now HealthSouth's chief operating officer.

After Columbia merged in 1994 with what was then called Hospital Corporation of America, Grinney continued his ascent and within two years was overseeing about 100 hospitals. In that position he had to deal with increasingly contentious decisions about which facilities to spin off or sell after the merger, and he was privy to the company's negotiating strategy as it settled its own Medicare billing scandal in 2002. But friends say Grinney believed that as a former Columbia exec, he had risen as far as he could. "I think he knew that the next CEO was going to come from the HCA side," says longtime friend William Remington. So despite warnings from some friends and family, he headed to HealthSouth.

With the company on death watch, Grinney jumped right into the bondholder dispute, working out a settlement that



COURTHOUSE STEPS

Scrushy's trial for accounting fraud began on Jan. 25

cost HealthSouth \$49 million. In early January, he agreed to end the Medicare fraud suit with a \$325 million payment. That leaves an SEC probe, private investor suits, and negotiations for a new credit line. While

Grinney and his predecessor, interim CEO Robert P. May, have closed nearly 300 unprofitable rehab and diagnostic centers, nearly one-fifth of HealthSouth's total, analysts say dozens more could go. And almost two years after federal authorities raided company headquarters in March, 2003, HealthSouth still hasn't been able to file an audited financial statement; Grinney says it will be another year before the company can give timely quarterly reports.

As if all of that weren't trouble enough, the company faces some daunting challenges to its basic businesses. For one, the propensity of medical-equipment makers to provide easy financing means that more orthopedic surgeons and other specialists now have the equipment to perform their own MRIs—a test that they previously outsourced to companies like HealthSouth. Even worse, while Medicare's general thrust is toward independent rehabilitation facilities such as HealthSouth's, a new billing guideline restricts the types of patients who can be admitted. Those recovering from a single hip replacement, for example, are now being steered toward nursing homes.

This change alone could shave HealthSouth's cash flow by \$118 million over the next three years, according to Balaji Gandhi, an analyst at Pacific Growth Equities LLC. "No matter what they do, the Medicare changes are going to make it difficult for them to grow revenues," he says. Grinney hopes to offset those losses by moving HealthSouth into the services he believes will be in great demand in coming years, such as skilled nursing and home health care.

And one day, when the Scrushy trial is over and HealthSouth's legal problems are behind it, Grinney hints he may change the company's name. If he could sell HealthSouth's palatial headquarters, sitting on 74 acres overlooking Birmingham, Ala., he would do that too. But so far, no other local company can afford it. ■

—By Dean Foust in Birmingham, Ala.



BIO

Jay Grinney

"I just like tackling things other people don't want to touch"

BORN Mar. 20, 1951, Racine, Wis.

UPBRINGING Both parents were medical doctors—father an OB/GYN, mother a general practitioner. Three brothers, including a twin, John.

EDUCATION BA in psychology, St. Olaf College, a small Lutheran school in Northfield, Minn., 1973.

MBA and Master's in Health Administration, Washington University in St. Louis, 1981.

CURRENT POSITION

President and CEO, HealthSouth, since May, 2004.

FIRST JOBS Dug ditches in high school. After badly blistering his hands on the first day, he got his twin brother to sub for him until

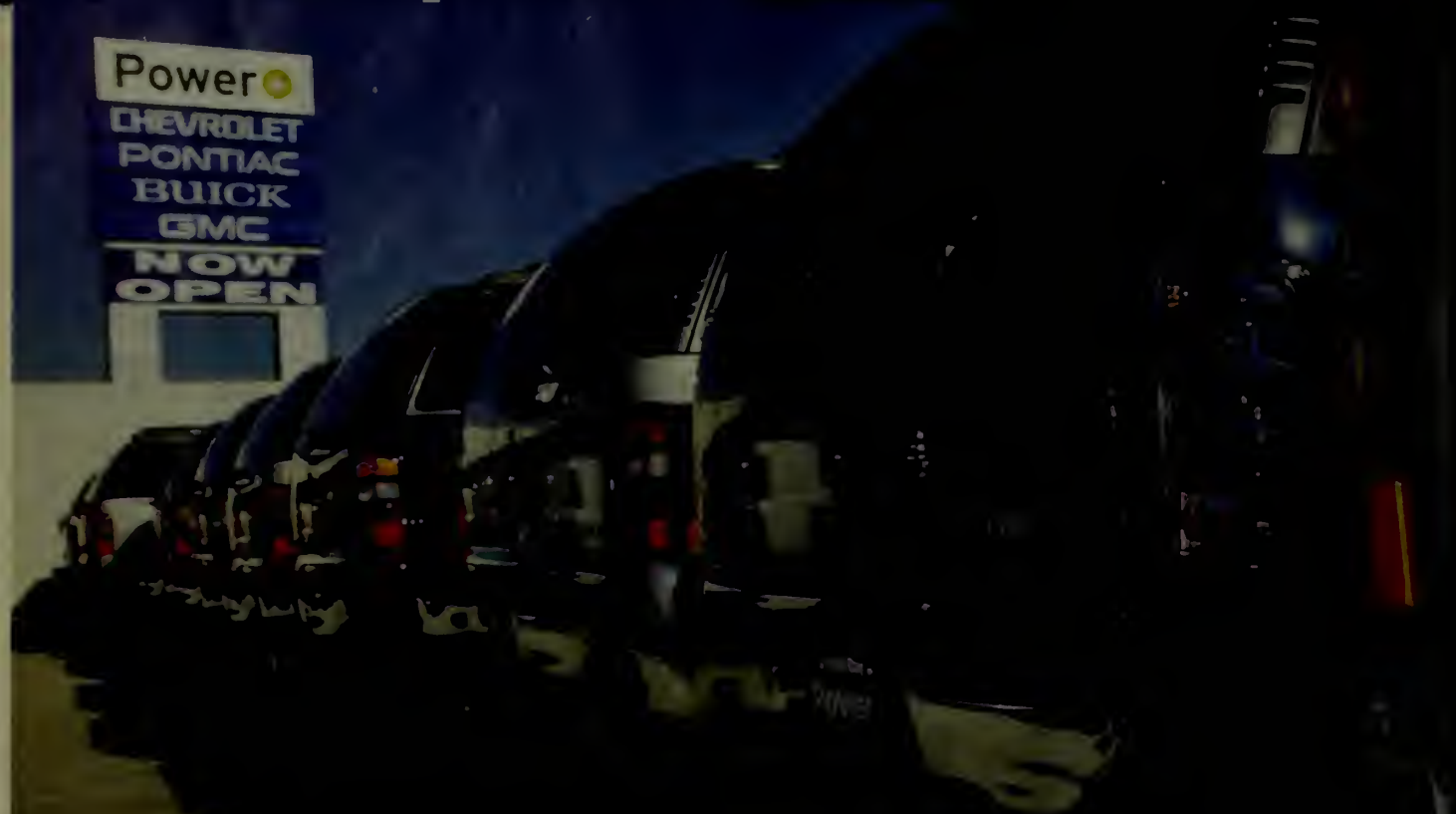
they had healed. During college he cleaned pens on a turkey farm.

CAREER PATH Worked briefly at a center for troubled children, then did social work. After grad school, joined Methodist Hospital in Houston as a management trainee. In 1990 jumped to Columbia Healthcare. Rose through the ranks after its merger with HCA. Named president of HCA's \$10 billion Eastern Group in 1996.

MANTRA "If it was easy, anybody could do it."

FAMILY Wife, Ellen Heath Grinney, is an author of books on health and metaphysics. Two daughters, Naomi and Rachel, and one son, Matthew, from a previous marriage.





GM Is Losing Traction

Its turnaround is threatened by sliding market share, high retiree costs, and the specter of a “junk” credit rating

A COUPLE OF YEARS AGO, General Motors Corp. finally seemed to be getting its act together. Profits were strong and the company had recorded back-to-back annual gains in auto market share—something that had not happened since the 1970s. Cadillac and Hummer were genuine hits—and, more important, big moneymakers. Former Chrysler Group star Robert A. Lutz was leading a renaissance in styling, stealing the spotlight at auto shows.

But today, despite billions invested in new cars, GM is once again losing ground. And suddenly its slide seems to be picking up speed. That point was driven home on Jan. 13, when Chairman and Chief Executive G. Richard Wagoner Jr. announced that he was moving to wall off his most reliable profit machine—the mortgage-lending portion of General Motors Acceptance Co.—bowing to the real possibility that his flailing auto business will be downgraded to junk status. Carving out the mortgage lending unit,

which contributed a cool \$1.1 billion to GM's bottom line last year, as a separate entity should preserve its credit rating. But finance profits are already shrinking, and could fall further in years ahead. And GM's scramble shows just how dramatically its options are shrinking. With fewer dollars to squeeze out of finance, the pressure is on to begin delivering significant profits from new cars and trucks.

HEALTH-COST SPIKE

THE GATHERING FEARS about GM's tenuous turnaround were crystallized when Vice-Chairman and Chief Financial Officer John M. Devine told analysts, also on Jan. 13, that auto profits in GM's vital home market will fall by more than half this year, to \$500 million, from \$1.2 billion in 2004. The news knocked more than 3%, or \$1, off GM's stock price. The biggest culprit: GM's retiree health-care costs are expected to spike by \$1 billion this year, to \$5.3 billion. Total 2005 earnings should tumble at least 20%, from \$3.6 billion to between \$2.3 billion and \$2.9 billion.

GM has struggled for years with its legacy of costly worker and retiree ben-

efits. Indeed, it's easy to view the company as a huge medical and pension provider with a side business in manufacturing. Each vehicle GM sells carries a crippling penalty of nearly \$2,000 for benefits paid to retirees. Its Japanese rivals, which began manufacturing here within the past 20 years, have far fewer U.S. retirees to worry about. A national pension system in Japan leaves them with much lower fixed costs in their home market. Not so GM. The company made only \$213 on average on each of the 5.4 million cars and trucks it sold in North America last year. That compares with \$1,472 for Toyota a year earlier. With lackluster models, its U.S. car and truck market share fell from 28% in 2003 to 27.2% in 2004. It could hit 25% by the end of the decade, says CSM Forecasting. Soon after, Toyota Motor Co. could supplant GM in worldwide sales leadership. GM says its ranks of retirees will begin to thin in five years, gradually easing at least that burden.

For now, though, GM heavily relies on its finance arm, which kicked in 80% of total profits last year. And that explain

WEIGHED DOWN
GM's legacy costs
amount to almost
\$2,000 per vehicle

capital, since many fund managers cannot buy junk bonds, and would raise the cost of any unsecured debt GM or GMAC tried to issue.

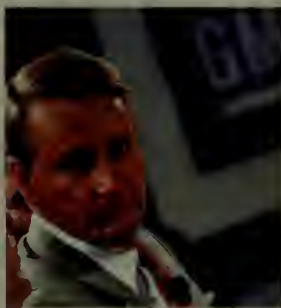
Any downgrade could raise GM's borrowing costs, cutting into profits on its lending business. To get around that, GM is already selling more loans to investors. But that will cut into long-term profits. Without a boost in auto earnings, that jeopardizes the parent company's goal of earning \$10 a share, or \$5.7 billion, in the next few years.

How bad could things get? GM's big retiree handicap and lower-cost competition has prompted some speculation that its only solution would be to follow steelmakers and airlines into bankruptcy. No one who seriously follows GM's finances sees that as an option, though. GM is solidly profitable, has too much cash—\$24 billion—and has more liquid assets that could be sold in a crunch than do, say, airlines.

But it's also clear that Wagoner's strategy of buying market share with steep discount pricing—while making up the difference on the finance side—has GM treading water. "GMAC will make money, but not as much," says Morgan Stanley analyst Stephen Girsky. "In the long run, the auto company has to make money."

GM is counting on new models of its big sport-utility vehicles and trucks to pick up the slack. They're going on their seventh year without a total redesign, which is why some models needed \$5,000 rebates at the end of last year. New Chevrolet Tahoe and GMC Yukon SUVs won't arrive until early 2006. New pickups come later. If the trucks sell well enough to cut \$1,000 in rebates, it is worth \$1.4 billion in pretax income.

But in the meantime GM still has too much factory capacity. It faces sharp new truck competition from Toyota, Nissan, and Hyundai. Costs of raw materials are soaring—its steel bill could rise by \$500 million this year, says UBS analyst Robert Hinch-



Wagoner is moving to protect GM's finance arm from a credit downgrade

liffe. And GM may have to cough up more than \$1 billion to wriggle free of its ill-fated investment in Italian carmaker Fiat. GM's auto business still generates cash, but it has slowed dramatically, from \$10.2 billion in 2003 to \$4.2 billion in 2004. This year, Devine says, cash flow will be just \$2 billion.

What worries investors is that any improvement on the auto side may not arrive in time to head off a credit downgrade. That's why GM executives are working feverishly to safeguard finance. A separate mortgage subsidiary would likely get its own credit rating, since its business is not related to autos. And it would feed

profits back to GM in the form of dividends, just like GMAC does now. Separating the mortgage business from GM should give it a higher credit rating. But GMAC Chairman Eric Feldstein argues that even if it kept GM's current BBB-rating, the mortgage unit would probably get lower borrowing rates. That's because GMAC already carries a sort of GM penalty—its borrowing costs are actually one percentage point higher than those paid by companies with similarly rated debt.

THERE'S A CATCH

FELDSTEIN IS ALSO changing GMAC's auto-lending business—which backs 45% of all GM car sales—to shield it against the risk of higher borrowing costs. The lender has begun selling more loans shortly after it originates them, to other lenders with better credit ratings. GMAC charges the banks origination and servicing fees. That fee income is predictable and it gives GMAC steady, cheap capital to keep writing auto loans.

There's a catch, though. In the near term, profits could rise, since having fewer loans on the books means GMAC can free up some reserves and book them as profit. But in the long run, GM's car-finance business could be less profitable. Lenders make less money from service and origination fees than they do on interest income. On any given loan, a lender typically makes a 1% profit. About three-quarters of that comes from interest and the other quarter comes from fees, says Thomas K. Brown, CEO of Connecticut-based Second Curve Capital. By selling off loans quickly, GM gives up interest income.

The strategy has a precedent: Ford

reassessment of GM's creditworthiness is such a threat. After Devine's slip-up about profits, the Standard & Poor's rating agency (which, like *BusinessWeek*, is owned by The McGraw-Hill Companies) issued a warning about the outlook, which it said was "stable" but a downgrade to BBB- in October. Investors took that as a hint that a downgrade to junk status may be in the offing. A lower rating would limit GM's access to

GM'S EARNINGS CRUNCH

Cars barely make a profit...



General Motors Corp.

...but now finance is weakening, too



Motor Credit Co. has been shrinking its balance sheet since 2001. A windfall from loan-loss reserves helped Ford Credit profits skyrocket to a record \$2.9 billion in 2003. But Ford execs admit that the gains aren't sustainable. They wouldn't be for GMAC, either.

Already, GM's finance profits are tightening as rising interest rates cut consumer demand. Total U.S. mortgage volume dropped 30% last year, to \$2.7 trillion, as interest rates jumped close to 1 percentage point in the summer. This

GMAC kicked in 80% of profits

is particularly bad news for GMAC, which benefited from a boom in home refinancing. Its mortgage profits fell 10% in 2004, to \$1.1 billion. Feldstein

says GMAC earnings will hit at least \$2.5 billion this year, guaranteeing a dividend to GM in excess of \$2 billion. That's down from \$2.9 billion in 2004.

Still, GM is a long way from the worst-case scenarios floated by some critics. Before it could qualify for bankruptcy, GM would have to tip into serious cash-negative territory. United Airlines Inc. lost \$5.4 billion in the two years before it went bankrupt in 2002, and it has avoided paying hundreds of millions in pension payments since. GM, by contrast, now has a \$3 billion surplus in its pension fund and won't have to make any contributions this year or next. Says Devine: "Anyone who thinks that bankruptcy is an answer is nuts."

Wagoner tried to make the same point on Jan. 13. He never mentioned the "B" word but offered up a short history lesson. He referred back to 1992, when GM's pension plan was underfunded by \$21 billion. The company was bleeding red ink; cash flow was a negative \$2 billion. Many investors figured that GM was doomed. Today, Wagoner said, GM is in the black, is cash-positive, and has \$23.5 billion in its coffers. His message: "The situation today is dramatically different, and dramatically better."

But Wagoner can't wait another 12 years to show results. His only hope is to do something that GM hasn't accomplished for three decades: generate lots of excitement with its cars. Until GM proves it can do that, Wagoner will have a very tough time quieting skeptics. ■

—By David Welch in Detroit, with
Nanette Byrnes in New York

Welcome to Procter & Gadget

The consumer giant is leading the way building brands with mechanical gizmos

IT LOOKS AS COOL AS AN IPOD and costs nearly as much: a sleek, handheld device that sprays ionized particles of makeup foundation on the face. But the company that will launch the \$200 appliance in the U.S. within a year is hardly perceived as a cutting-edge gadget maker. It's Procter & Gamble Co., the Cincinnati consumer-goods company best known for household staples such as Pampers, Crest, and Tide.

The SK-II Air Touch, already selling in Japan and Britain, is leading a P&G strategy to jazz up those humdrum brands by placing them inside nifty new delivery devices. Not coincidentally, that also allows the company to boost pricing. It's a lesson P&G learned from watching Gillette's well-worn razor-and-replacement-blade strategy and its own runaway success with its \$14 Swiffer mop (and \$5.75 replacement pads) and the \$7.69 SpinBrush electric toothbrush. P&G is spreading the strategy to multiple categories, redefining how it interacts with consumers and using the experience that is created through a device to foster greater loyalty to its brands. Says longtime P&G consultant Gary Stibel of New England Consulting Group: "It's a substantial shift in how P&G is thinking about brands."

Rivals such as S.C. Johnson & Son Inc. and even blade king Gillette Co. are also

placing bigger bets on gadgets. But P&G is stepping on the gas. In the past year, it has launched at least eight mechanical or electric gizmos. They include Febreze Scentstories, an electric air freshener; Tide Buzz Ultrasonic Stain Remover; and Tide StainBrush, a battery-powered brush. It also introduced Swiffer Swiffer + Vac, a device that combines a Swiffer electrostatic dust mop with a vacuum, and Mr. Clean AutoDry, a water-sure-powered car-cleaning system that dries without streaking. Sales of P&G's gadget-related items grew last year and now total about 8% of the company's \$54 billion in annual sales. That's up from 2% in 2000, estimates Lehman Brothers Inc. analyst Ann Gillin. Let's

COFFEE PADS

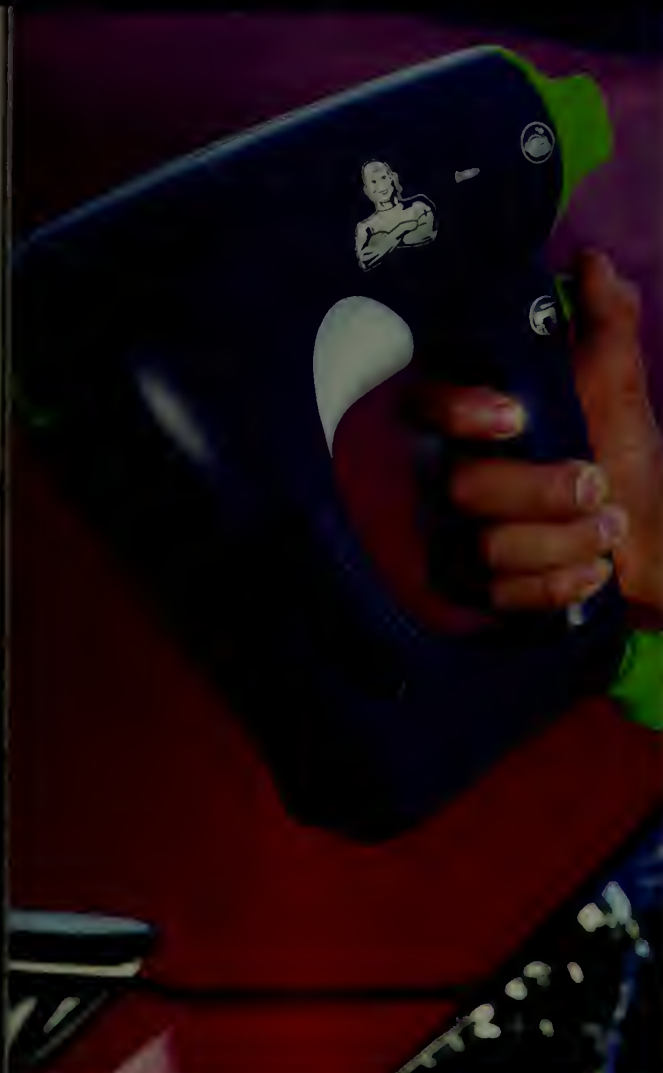
CONSUMER-PRODUCTS companies are finding new growth wherever they can find it. Sales in packaged goods are craving a boost, and P&G is leading the way ahead at just 3% annually. Gadget-related items only create new sales but also drive future sales through replacement items. P&G is advancing that strategy by partnering with appliance makers who make hardware to support unique P&G products. Last year, home-appliance maker Appliance Inc. launched the Home Café, a one-touch coffee maker that uses distinctive Folger's and Millstone coffee pads from P&G.

Batteries Required

Consumer-products companies see gadgets as a way to hook consumers—and raise prices.



ORAL-B HUMMINGBIRD
Gillette's underdog Oral-B Hummingbird electric toothbrush is the latest wave of oral care products. The company's tongue scrapers and toothbrushes are more into their sales than ever. Price: \$7.29, \$2.99 for the Hummingbird.



MR. CLEAN AUTO DRY

Items like this car cleaner help P&G boost margins

vices is one reason P&G has been able to absorb rising costs of raw materials better than rivals Unilever Group and Colgate-Palmolive Co., which haven't followed the gadget strategy, says Banc of America Securities analyst William Steele.

P&G Chief Executive Alan G. "A.G." Lafley believes the most important aspect of his gadget approach is its potential to increase brand loyalty. Since taking the top job in 2000, Lafley has expanded the definition of P&G's big brands. Instead of just toothpaste, for instance, Crest now includes whitening products and the

low-price electric SpinBrush line. The cheap, fun-to-use brush, Lafley says, has created a new and positive vibe around the whole Crest brand. "People remember experiences," Lafley notes. "They don't remember attributes."

Competitors are taking note. Last year, Gillette launched its M3Power battery-powered wet shaver after a first-time collaboration among the company's razor group, its Braun appliance division, and its Duracell unit. Clorox Co. introduced Swiffer competitor ReadyMop. S.C. Johnson rolled out Scrubbing Bubbles Fresh Brush, a toilet cleaning brush with a flushable disposable head that requires refills, and is testing a gadget under the same brand that hangs in the shower and

automatically cleans the tub and tile.

Are companies creating demand by inventing new categories or responding to consumers' wants? Both, say executives and consultants. "Inexpensive personal care gadgets is where the desire to self-pamper meets the gadgeting of our briefcase, belt, and car," says independent marketing consultant Dennis Keene. Add a willingness to spend more on personal grooming by baby boomers and Generation X, plus a growing distaste and lack of time for housecleaning by the same consumers, and it adds up to a huge opportunity for new devices, Keene says. Gillette's M3Power did little else but make the disposable razor head vibrate, but that was enough to grab 35% of the U.S. razor market in dollar terms and 6% of the disposable blade market within a short seven months of launch. "This has the potential to be the biggest-selling product ever in the blade and razor market," says Peter K. Hoffman, president of blades and razors at Gillette.

But there is clearly a fad worry to the gadget boom. As consumer-products companies generate new devices, margins inevitably will contract, predicts William A. Sahlman, a Harvard Business School professor who has studied the success of SpinBrush. Consumer demand for such devices, too, is difficult to gauge. And execution isn't always on target. Drug chain Walgreen Co., for example, reports that sales of P&G's \$7.49 Dawn Power Dish Brush have eased since its launch in 2003. And some Procter & Gamble managers worry about the quality of devices, which can ultimately hurt the overall brand. P&G recently had to recall the Swiffer Vac because of electrical problems.

Lafley acknowledges there's no telling when consumers will max out on gadgets. "We have to be careful we don't push it too far," he admits. But for now, P&G is determined to find new ways to pack consumers' cabinets with nifty gizmos. ■

—By Robert Berner in Cincinnati, with William C. Symonds in Boston

BusinessWeek online For a slide show on gadgets, see www.businessweek.com/extras

Philips Electronics introduced a Sonicare electric toothbrush that calls for specially formulated Crest toothpaste. These profitable devices are lifting otherwise stagnating profit margins of soaps and household cleaners, thus offsetting price pressure on sales in developing countries. And while consumer-products companies typically struggle to win any price increases these days, P&G is launching a \$34 higher-powered premium version of AutoDry that also works inside the tub and costs 70% more than the original. It beats a 22-ounce bottle of Mr. Clean at \$2.99. By signing up contract manufacturers to make the devices, P&G gets lower capital costs. Profit on these de-

BUZZ

in-gadget, as an wand and side cleaner. Price: \$29.99, plus refills at Target. Stain-removing sticks run about \$2.99.



VENUS VIBRANCE

The women's version of Gillette's battery-powered M3Power razor and blade system hits the market this spring.

Price: About \$10 for the starter kit—50% more than the nonpulsating shaver.



SK-II

Procter & Gamble's electric applicator for makeup foundation. Designed to replace the trusty (and cheap) sponge, the Air Touch is already selling in Britain and Japan and should arrive in the U.S. within a year. Price: About \$200.



Microsoft May Be A TV Star Yet

After a decade of stumbles, the giant is winning over cable and telecom players

HISTORY WILL REMEMBER Microsoft Corp. as one of the greatest business success stories. But the company has suffered its share of ignominious failures, too. There has been no business where Microsoft has spent so much for so long and achieved so little as its foray into television technology.

Until now. After more than a decade of trying to crack the TV software business, Microsoft's persistence is starting to pay off. The first sign came last November, when cable-TV industry leader Comcast Corp. rolled out set-top boxes running Microsoft's TV software to its Seattle customers. Since then, Microsoft has landed deals with two Bells—BellSouth and SBC Communications—as they charge into competition with cable operators. And *BusinessWeek* has learned that Verizon Communications Inc., the Bell that's making the most aggressive foray into television, plans to use Microsoft's technology for its TV service, beginning with its initial rollout in the second quarter. "We have a shared vision of how the world is evolving," says Shawn Strickland,

director of Verizon's new service, FiOS TV.

Microsoft's burst of progress comes just as the TV business is on the verge of massive change. Deep-pocketed telecom companies are starting to move into the market, challenging cable players that are offering telephone service over their networks. The resulting battle has both sides racing to roll out new, sophisticated TV services, including vast libraries of movies on demand and personal video recording.

ENORMOUS POTENTIAL

THE KEY TECHNOLOGY for delivering these services is something called Internet protocol television, or IPTV. The technology can be used to offer a dizzying array of options: *Desperate Housewives* anytime you want it, the Super Bowl from a dozen different camera angles, and a nearly limitless number of channels. Telecom companies are embracing IPTV since they're building their TV systems from scratch. Cable companies, which use older technology, are likely to begin migrating to IPTV over the next five years. Analyst Hervé Uteza with the Diffusion Group Inc. estimates that 15.3 million homes will subscribe to IPTV services worldwide by 2008, compared with 184 million

using traditional cable technology.

Microsoft, if it plays its cards right, could end up smack dab in the middle of this emerging business. Its IPTV software is only in small trials and in telecom company labs, but experts say it's the early leader in this nascent market. "Microsoft's platform is the most promising," says analyst Josh Bernoff of Forrester Research Inc. "There will be a lot of Microsoft software on set-top boxes five years from now."

Initially the payoff may not be huge. Microsoft gets \$2 to \$5 for each set-top box that uses its software, which manages the electronic program guide, digital video recording, and other

I Want My **IPTV**

While **Microsoft** sells software to cable systems, its biggest plans focus on Internet protocol television, or IPTV, which telecoms will roll out later this year. Why it's hot:

LIMITLESS PROGRAMMING Cable companies typically offer 120 to 250 channels, but the number is limited by the capacity of their networks. IPTV has no limits. Its more flexible Net technology lets viewers get traditional TV shows, video-on-demand, and video-spouting Web sites.

MULTIPLE PICTURES Today viewers can get a second, tiny picture frame on their screens only if they have special TVs with second tuners. IPTV does that with software and can even offer multiple screens on a big-screen TV so sports fans can keep tabs on several games at a time.

POTENTIALLY LOWER TV BILLS Right now consumers can choose a local cable company—a monopoly with high prices—or one of a smattering of satellite TV services. When telecom companies start offering IPTV, increased competition could put pressure on prices.



PLEASER
get
angles or
at once

aspects of the viewer's experience. Right now the bigger-ticket item is the software to power the mondo servers that do everything from dishing up programming to managing anti-piracy protection for video content. Analyst Rick Sherlund of Goldman Sachs & Co. estimates that Microsoft's total TV revenues will be less than \$1 billion for the next several years. Yet the growth potential is enormous. With 1.7 billion TV sets worldwide—more than double the number of PCs—Microsoft's television initiative could ultimately blossom into a mega-business.

NO SURE THING

THE BID'S STRATEGIC importance may trump its revenue potential. Chairman William H. Gates III is betting that Microsoft will land enough TV deals that it will play as significant a role in the living room as it does in the office. Gates envisions a time when set-top boxes snap into a network of digital products—with the PC at the center, of course—that shoot video, music, and photos around the house. He declines to predict specific revenues but says Microsoft eventually will recoup the nearly \$500 million it spent on TV software over the past decade. "It will absolutely pay back those early years," he says.

Yet Microsoft's success is far from a sure thing. Building technology for the next generation of TV is tricky. There's no certainty that Microsoft's products will outpace those of its competitors—which include equipment makers Siemens and Alcatel and smaller companies such as Kasenna. In addition, some potential customers have reservations about doing business with the company that thoroughly dominates the PC industry. They're either steering clear of Microsoft altogether or avoiding lock-in by mixing and matching technologies from Microsoft and others. "There's a certain level of caution companies have when they work with Microsoft. It won't be in the monopoly position it has had with the PC business," says Verizon's Strickland.

Shoddy technology, arrogance, and poor timing derailed Microsoft's earlier efforts. In 1994, with great fanfare, Microsoft unveiled its first advanced TV project, Tiger, which stored video on computer servers and shot them to viewers at their request. At the time, the cost of the technology made the system prohibitive. Microsoft kept plugging away through acquisitions and new products but never

managed to get any traction. One reason: It tried to push its own brand in front of viewers, alienating cable operators.

To claw its way back into contention, the company has had to rethink its strategy—and eat a bit of crow in the process. Since taking over the TV business two years ago, Vice-President Moshe Lichtman has toned down Microsoft's efforts to promote its own brand. "They understand that it's an SBC service. It's not Microsoft," says Lea Ann Champion, senior vice-president for information-processing operations and services at SBC, which gave Microsoft the largest IPTV software deal ever, agreeing to pay the company \$400 million to provide TV software for the next 10 years. Subscribers won't see any Microsoft branding at all in SBC's offering.

Most surprisingly, Microsoft no longer insists that set-top boxes run a trimmed-down version of Windows, known as Windows CE. Instead, while Microsoft's first IPTV product runs on Windows, later versions will be designed to run on operating systems from Motorola Inc. and other rivals.

JUST-IN-TIME CHANNELS

WHILE THE SCOPE of Microsoft's opportunity is still in question, there's little doubt that IPTV will change the way couch potatoes get their programming. Today's cable systems were designed to have every channel they offer flow to each set-top box at the same time—ready for the viewer to select one. But with all of that programming clogging the cable into a home, cable operators can offer only a limited number of channels.

IPTV does away with that design. Only one program shoots into a set-top box at a time. When a viewer clicks to a new channel, the set-top box notifies a computer server at the IPTV operator's facilities to instantly send a new stream of programming. This superefficient design gives viewers no end of choices. Down the road, IPTV providers expect to be able to let customers roam the Internet in search of interesting video too—whether it's news clips, blockbuster films, or a blogger's home movies.

Gates is confident that consumers will want IPTV. "People care about the TV viewing experience. If you can really make it better, it has a really profound impact," he says. If Microsoft can pull this off, it might be able to turn its decade-long slog in TV technology into a sprint. This show is about to get interesting. ■

—By Jay Greene in Redmond, Wash.,
with Heather Green in New York
and Andy Reinhardt in Paris

ON THE RECORD

Aiming for 'A Very, Very Good-Sized Business'

MICROSOFT CORP. IS ONE of the few companies that invests in interactive TV technology when it came into vogue a decade ago and is still in the game. Chairman Bill Gates sat down with Seattle Bureau Chief Jay Greene to discuss why he thinks the business is finally ready to take

On whether Microsoft got into interactive TV too early:

We're not like day traders where we say: "Oh, let's time our entry into the software market and not get there a day early." We are believers in the power of software. Anywhere we see a chance for great software, we're going



GATES Just "see the best parts" on TV

to invest in it and we're going to just stick with it. It's very important for us to have gotten in early to do a TV platform. Since we've been working all this time, we really have the software ready.

On why Microsoft is making progress now with interactive TV:

It's not so much that we changed anything. We did breakthrough work in this whole vision of IPTV [Internet protocol television, which uses Web technology to deliver programming]. We persevered, and now both on the cable side and telco side we found a way for our software to fit and improve the TV experience.

On what IPTV offers consumers:

Whether it's game shows or sports news or advertising...you should have a show that fits what you're interested in. When you watch sports you have 20 minutes, [you should see] the best parts. But then [you should be able to control and say: "Now I would like to see a little bit more of that play." Even the idea of being able to talk with your friends, video chat, audio chat or text chat while you're watching shows at different locations. That stuff gets incredible response and it's only when you get that framework that you get the chance for that kind of innovation.

On what cable and phone companies get from IPTV:

I think Comcast is still figuring out what an incredible platform they've got with our software. [If] they want to survey their customers about this, that, they can decide to do that in the morning and have results in the afternoon. They've never had a software platform like this.

On how big a business Microsoft TV could become:

Well, if we win a substantial number of the cable and telecom deals around the world, then you could see a pretty good-sized business. Not a Windows-sized business but a very, very good-sized business. And that is reinforcing all the other work we're doing—media [compression technology], our digital-rights management. It's a great thing for getting other efforts around the company to critical mass.

BusinessWeek online For an extended Q&A with Bill Gates, go to www.businessweek.com/extras

ED BY OTIS PORT

NOVATIONS

Orange peels carbon-eaters

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MED TECH

CAN A SOLAR CELL HELP THE BLIND TO SEE?

MORE THAN 10 million Americans are thought to have macular degeneration and retinitis pigmentosa, diseases of the retina that often result in blindness. Help may come in the form of an artificial retina made from photovoltaic chips—the same kind that turn sunlight into electricity. Surgeons at three hospitals began inserting the slivers of silicon, made by Optobionics Corp., into the eyes of legally blind volunteers in late January. Smaller than an “o” in this

text, the chips are placed behind the retina, where doctors hope they will convert light into electrical pulses, effectively replacing the eye's light-sensing cells destroyed by disease.

In earlier tests, patients reported limited improvement in sight within a few months, says Dr. John Pollack of Rush University Medical Center in Chicago, which is involved in the clinical trial. Patients in the latest test will be monitored for two years.

—Michael Arndt

PROCESSORS

CHIPS THAT SIP, NOT SLURP

IMAGINE USING your cell phone or MP3 player for a week or two without recharging it. Researchers at Georgia Institute of Technology say it may soon be possible, thanks to a new concept in silicon chips that does more with less energy.

Today, processors use lots of energy to be absolutely certain that each data bit is either a 0 or 1 at every step of a calculation. But if an application doesn't need such certainty—and many don't—

then energy consumption could be greatly reduced, and speed would get a boost. After testing one of his prototype chips, researcher Krishna Palem concludes that a hundredfold improvement could be an easy target.

Processing voices is one task that could tolerate less certainty, as minor errors are unlikely to make an audible difference. But even sophisticated tasks such as financial analyses, risk assessment, and cryptography are candidates.

EXTREME TRAVEL

PICKING UP THE PACE OF THE SPACE TOURISM RACE

THE RACE TO privatize space travel has already produced a few starstruck entrepreneurs. One is Virgin Atlantic Airways chief Richard Branson. He plans to launch a suborbital space tourism business in three years, with five “spaceliners” modeled on aerospace pioneer Burt Rutan's now-famous SpaceShipOne. Some 13,500 people have asked for a reservation.

To heighten competition, Las Vegas hotelier Robert Bigelow and friends are funding a \$50 million contest called America's Space Prize. His own startup, Bigelow Aerospace, aims to put a small hotel into orbit in 2010, but it'll need space taxis to ferry people there. So the new space prize will go to the first private company that sends a five-person spaceship around the earth twice at an altitude of 250 miles—four times higher than SpaceShipOne's record-breaking flight last year.

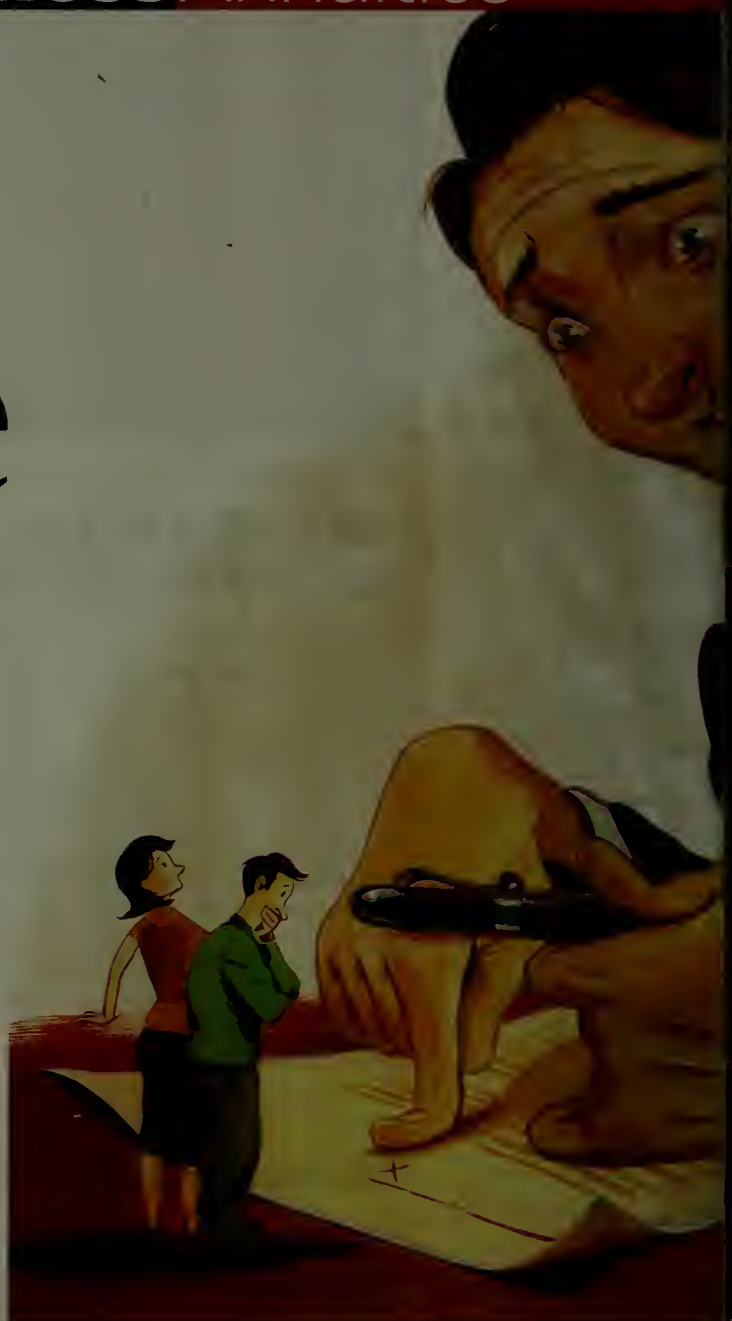
In mid-January, Space Exploration Technologies got off to an early start by test-firing a powerful rocket engine for almost three minutes—long enough to boost 1,500 pounds into orbit. Five engines could be lashed together for the purpose of lofting space taxis. Better known as SpaceX, the El Segundo (Calif.) company was founded in 2002 by Elon Musk, who made his fortune as a dot-com entrepreneur.



FIRED UP Testing SpaceX's rocket

Don't Believe The Hype

Many of the tax benefits of variable annuities no longer exist, but the hard sell continues. **BY ELLEN HOFFMAN**



HAVE YOU BOUGHT A variable annuity yet? If you're a baby boomer and your answer is no, get ready for the hard sell. The promoters of these savings vehicles will prey on your insecurity about not having enough money for retirement to get you to sign up for what could be a costly investment. Even if you already have a variable annuity, someone may try to convince you to trade in your existing contract for one with new bells and whistles—in which are buried higher fees. The problem with variable annuities is they are often a high-cost answer to a problem that may have simpler, cheaper solutions, such as fully funding your tax-deferred retirement accounts or assembling a portfolio of reliable dividend-paying stocks (page 92). Still, through Sept. 30, 2004, variable annuity sales were

\$98.4 billion, about 4% higher than the same period in 2003. And insurance salespeople, not Wall Street brokers, who are making most of the sales, have been cool to the product. Variable annuities “are tax-inefficient, difficult to understand, and have high costs,” says Warren McIntyre, a financial planner in Troy, Mich.

Sure, potential buyers can ignore the sales fluff and dig into the fine print to figure out if an annuity is right for them, but that can be a real slog: The prospectus for MetLife's Preference Plus Select Variable Annuity runs over 500 pages, so you know why most buyers wind up signing on a sales spiel.

The legions of sales folks are spe-

these annuities run 5% to 7%, says the NAVA, which, in the investment world these days, is a pretty big number.

DISGRUNTLED BUYERS

AS AGGRESSIVE SALES practices rise, so has the number of disgruntled buyers pleading their case to regulators. These annuities "have received more than their proportionate share of complaints, compared to their sales," says Mary Schapiro, vice-chairman of the NASD, the regulatory body formerly known as the National Association of Securities Dealers. Customers made some 7,000 complaints about variable annuities in 2003, says the NASD. The regulator has not yet compiled the 2004 numbers, but says the complaint level remains high. Jim Poolman, North Dakota's insurance commissioner and chairman of the Life Insurance & Annuities Committee of the National Association of Insurance Commissioners, says his group was so concerned about "churning"—getting annuity owners to swap their old annuities for new ones—that in 2003 it wrote a model law that makes the annuity salesman responsible for assuring the product

is suitable for the prospective buyer. The law has so far been adopted in five states.

What exactly is this product that so many are eager to sell? A variable annuity is a contract with an insurance company designed to beef up your assets before you re-

Sales fees on annuities run 5% to 7% these days

tire. You buy the annuity, either with periodic payments or in a lump sum, and then invest the money by choosing from a selection of stock, bond, and money-market funds, or in annuity parlance, "subaccounts." It's a "variable" annuity because the returns vary depending on how the underlying investments perform. Many variable annuities also offer an option of a minimum guaranteed rate of return.

At some point, perhaps when you're ready to retire, the idea is that you annuitize the cash you've accumulated over the years. That is, the insurance company will pay you a monthly fixed sum based on the value of the nest egg, your age and life expectancy, and whether you want to retain any income for your beneficiaries. But only about 1% of variable annuities are

CRIB SHEET ON VARIABLE ANNUITIES

Some terms you need to know:

ANNUITIZATION Converting the value of the annuity into a series of income payments for your lifetime, or for a specified period of time.

DEFERRED ANNUITY A contract that allows you to start receiving income payments in the future.

DEATH BENEFIT Payment to a beneficiary on the death of the annuity owner, usually whatever's greater: the amount invested or the current contract value.

ENHANCED DEATH BENEFIT

Owner pays an extra fee for an increased death benefit.

IMMEDIATE ANNUITY A contract to start receiving income payments immediately.

MORTALITY AND EXPENSE RISK CHARGE (M & E) A fee that covers the annuity's insurance guarantee of a lifetime payout option, and a basic death benefit. Annual average cost is 1.01% of the annuity's value.

SUBACCOUNTS Stock, bond, and money-market funds you use to invest the money in your annuity.

SURRENDER CHARGE A penalty for taking money from the annuity before the end of a specified period. For example, over a seven-year period, the cost might be 7% of the annuity's value the first year, decreasing 1% each year until the penalty reaches zero.

WITHDRAWAL Taking money out of the annuity without converting the value into a series of scheduled annuity payments.

Data: National Association for Variable Annuities, BusinessWeek

Personal Business Annuities

ever annuitized. Most people leave the money in the variable annuity, and withdraw it as needed.

In many respects, the variable annuity sounds like a mutual fund, but it has key differences. First, if you die, the insurance company promises to give your beneficiaries at least the amount you invested. That's why in addition to the ongoing investment management fees of a mutual fund, the annuities levy a "mortality and expense risk charge" which pays for that life insurance-like feature. The average M&E charge is 1.01% a year. Another option is an enhanced death benefit, which will increase the guaranteed payout to your beneficiaries—

Know the common sales pitches and how to respond to them

feral may be unwise for many investors. Here's why: If you invest your annuity in stocks, they'll produce both long-term capital gains and dividends, which right now are taxed at a maximum rate of 15%. But long-term gains and dividends earned in the annuity will eventually be taxed as ordinary income, usually at a much higher rate.

Annuities come with a host of fees and conditions. The average annual expense for a variable annuity in 2003 was 2.32% of the value, says the NAVA, compared with 1.4% for an equity mutual fund. Another cost that may come into play if you want to break the contract is the surrender charge. That's an early withdrawal penalty

couple, that's taxable income (\$119,950), you will likely be better off taking the money you would have in an annuity into some well-known stocks or mutual funds in an ordinary account. Sure, you pay taxes on dividends or earn capital gain; they'll be, at most, taxed at the 15%. With the annuity, those profits could be subject to much higher rates.

» It pays to trade in your old annuity for a newer, better version.

Annuity marketers say if you're a healthy retiree, expecting to live quite a while more years, you should trade in your old annuity to get one with some of the features that weren't available when you purchased your old contract, such as the guaranteed minimum withdrawal benefit. The benefit ensures that you can withdraw a certain amount, say, 7%, of your principal a year, even if the value of the account has gone down. The feature adds 0.25% to 0.65% a year in costs. However, even if you trade into a new contract not only drums up new fees, it forces you to lock up your money for a certain period. You also may face a schedule of stiff surrender fees.

» A variable annuity is the best way to guarantee your income will last as long as you live.

By definition, the value of a variable annuity fluctuates with the performance of the underlying investments. An annuity without an income guarantee runs the risk of declining in value if the market slumps. Such guarantees can add 0.25% to 0.75% a year in costs.

» You're going to need an annuity when you retire, so you'd better buy it now.

You don't have to buy a variable annuity now to get annuitized income later. At any point, such as when you retire, you can take a lump sum out of your 401(k) and purchase an immediate annuity, either fixed-rate or variable.

» A variable annuity is a good way to transfer wealth to your heirs.

An annuity allows you to say you want to receive whatever proceeds are left when you die. However, your heirs will have to pay ordinary income tax on the money you bought a life insurance policy in the money would pass along tax-free.

which declines over a specified period. For example, you may pay 7% of the annuity value to get out the first year, 6% the second year, and so on until it reaches zero after seven years.

As a consumer, the best way to arm yourself against the pressures of annuity marketers is to know the common sales pitches and how to respond to them.

» A variable annuity is the most tax-efficient way to save for retirement once you've maxed out your 401(k).

Not so. If you're subject to a marginal income tax rate of 28% or higher (for a

say, an extra 5% a year. Of course, that adds to the cost.

The variable annuity also differs from a mutual fund in that the investment earnings, like those of a 401(k) or individual retirement account, are tax-deferred. You pay the tax when you start taking the money out of the account—and you can do that at age 59½ without incurring a penalty. Unlike the other tax-deferred retirement plans, the annuities have this advantage, and there's no limit to how much you can stash away.

That tax deferral was a critical selling point for many years, but now such de-

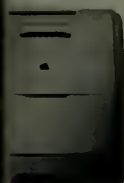




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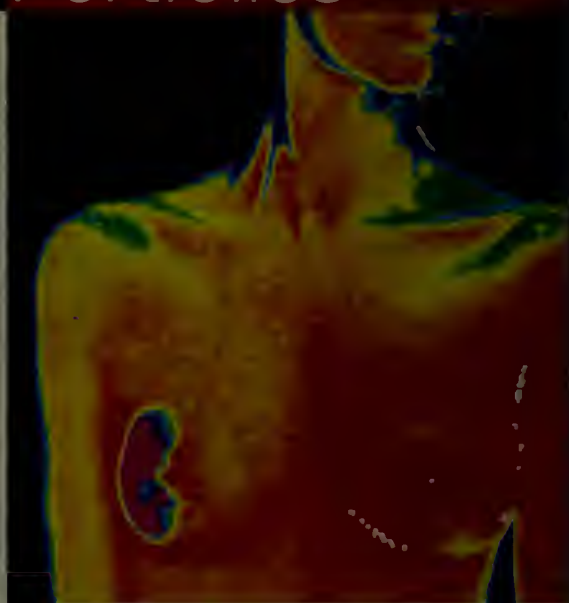


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Investing to Fight Disease

It may be better for your soul than for your bottom line. **BY CAROL MARIE CROPPER**



BREAST. CANCER. DIABETES. Alzheimer's. Almost everyone knows of someone suffering from one of these diseases. But does it make sense to put your money into an investment built around companies searching for treatments?

That's the question raised by five new unit investment trusts that target Alzheimer's, breast and ovarian cancer, diabetes, prostate cancer, and rheumatoid arthritis. Developed last year by WellSpring BioCapital Partners in Philadelphia, VIOLTs, short for Vertical Investments of Life Sciences Trusts, hold shares of companies developing or marketing treatments for these diseases. Their creator's pitch is they provide an easy-to-understand way to invest in health care.

Others call the investments a gimmicky appeal to investors' hearts rather than their heads. "It seems to be an idea that exists because it can be sold to people rather than because it's a good investment," says Christopher Davis, an analyst at fund researcher Morningstar. "If you really care about prostate cancer, diabetes, or Alzheimer's, you're better off contributing to an organization that specializes in disease research," he adds.

Each trust contains 12 to 23 stocks, compared to about 70 in the average health-care mutual fund. While household names such as Eli Lilly, Johnson & Johnson, and Bayer are part of the mix, so are small outfits like Axonyx, a biotech developing Alzheimer's drugs. It lost \$19.8 million through its third quarter, which ended on Sept. 30. Another investment, Cell Genesys, which is working on a prostate cancer vaccine, lost \$97.5 million in 2004.

An investor should first weigh the pros

and cons of betting on a unit trust vs. a mutual fund. A trust is a static investment. Unlike a fund, its stocks are chosen at the outset and do not change. That should make a trust more tax-efficient than a managed mutual fund in which stocks are bought and sold. Also, you'll know exactly what your unit trust holds. Finding out the current holdings of a mutual fund is virtually impossible.

A Long Time To Stay Put

WellSpring BioCapital Partners has developed what it calls Vertical Investments of Life Sciences Trusts, or VIOLTs, which hold shares, without buying or selling, for five years. Here are WellSpring's five VIOLTs and their top holdings, with ticker symbols.

ALZHEIMER'S DISEASE VIOLTs (FTAZSX)

Shire Pharmaceuticals Group (SHPGY)
Elan (ELN)
H. Lundbeck A/S (LUN.DC)

BREAST AND OVARIAN CANCER VIOLTs (FTOVXS)

American Pharmaceutical Partners (APPX)
Medarex (MEDX)
Cell Therapeutics (CTIC)

DIABETES VIOLTs (FTDBSX)

Nektar Therapeutics (NKTR)
Eyetech Pharmaceuticals (EYET)
Amylin Pharmaceuticals (AMLN)

PROSTATE CANCER VIOLTs (FTPCSX)

Myriad Genetics (MYGN)
Medarex (MEDX)
Bayer (BAY)

RHEUMATOID ARTHRITIS VIOLTs (FTRASX)

Cambridge Antibody Technology Group (CATG)
Chugai Pharmaceutical (4519.JP)
Amgen (AMGN)

On the other hand, a lot can happen to a health-care portfolio during the life of a unit trust (in this case, five years). Without a manager culling weakening stocks, your only would be to liquidate the VIOLTs receive the underlying net asset value (NAV)—the value of the holdings minus any fees or loads due. (On Jan. 24 through Jan. 25, 2005, all five trusts were below the \$10 price of Sept. 15, 2004, according to www.ftportfolios.com, a Web site for Trust Portfolios, which underwrites and distributes unit investment trusts the sponsor of the VIOLTs.)

HIGH PRICE OF ADMISSION

STEEP EXPENSES ARE another issue. In the first year you'll pay 4.95% in expenses, plus a one-time "organization charge" of 0.29%, as well as an annual fee expected to run 0.25% to 0.32%. Comparing that with the 1.93% in annual fees charged by the average health-care fund, A fund probably charges more over five years but less at the outset, leaving more to grow and appreciate.

WellSpring CEO Sam Katz calls the criticisms the investment community's reaction to a product it didn't want, adding that VIOLTs are a way to let investors while supporting treatment that could make their own lives better. "a double bottom line," he says. But a rational investor may decide the bottom lines most likely to benefit those of the folks selling VIOLTs.

SCAN SHOWING
CANCER Betting on far-off drugs likely to be helpful for your portfolio

BusinessWeek online For a complete list of the VIOLTs stocks, please visit us online at www.businessweek.com/magazine/ext

Data: WellSpring BioCapital Partners

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BIG BUYS Taxes on items such as cars may be deductible for you

The alternative rely on the the IRS' Publication 600 (available at www.irs.gov)

up your home state—since sales tax rates vary, so do the deductions. The amount you deduct will also depend on your family's size and adjusted gross income (a few nontaxable items, such as exempt interest, added). For example, the tables allow an Illinois resident with exemptions and \$120,000 in adjusted income to deduct \$1,611.

What about local sales taxes?

Since the IRS tables are based on state sales tax rates, those who pay a local sales tax will have to do some extra work using the worksheet in Publication 600. Give the Illinois family above a Chicago address, for instance, and it can claim an extra \$644.40 in deductions for sales tax payments (table). That increases the deduction to \$2,255.40.

What if I bought a big-ticket item?

If you bought a boat, car, truck, or other item listed in Publication 600 or a motor vehicle, add the sales tax you paid to the table amount you're allotted. For a \$30,000 car purchase, the Chicago family's total sales tax deduction comes to \$4,880 (table). That exceeds the state income tax deduction allowance of \$120,000 of taxable income.

Should I save receipts in 2005?

It's worth saving your receipts if you think you spend more than the IRS assumes. To figure that out, start by adding up your deduction in Publication 600. Then, divide by your state's sales tax rate. Since Illinois has a 6.25% sales tax

Should You Take This Tax Break?

The new sales tax deduction may be worth claiming, but crunch some numbers first. **BY ANNE TERGESEN**

IF YOU LIVE IN ONE OF NINE states with no income tax on wages, here's some good news: A new law lets you deduct state and local sales tax on your federal return. The break is good only for this tax season and next, unless Congress acts to extend it. For everyone else, the new law gives you the option of deducting either your state and local sales tax or your state and local income tax—but not both. As a result, you'll have to crunch some numbers to see which deduction gets you the most savings.

If you pay state income tax, chances are you'll come out ahead with the income tax deduction. But there are exceptions. Big spenders should run the numbers. So should residents of states, including Illinois and Michigan, where income tax rates are lower than the sales tax rate, says John Logan, senior state tax analyst at CCH Tax & Accounting in Riverwoods, Ill. Here are answers to some questions about how the sales tax deduction works.

I haven't saved my receipts. Can I claim the sales tax deduction?

Yes. The Internal Revenue Service gives you two ways to claim this deduction. The first is to use your actual expenditures.

TO CALCULATE your sales tax deduction, use this worksheet from IRS Publication 600. We've done the numbers for a family of four from Chicago with \$120,000 in adjusted income. On Line 1, enter either your actual tax expenditures or the amount the IRS estimates you spent from table in Publication 600. Line 3 is sales tax from purchasing a \$30,000 car.

State and Local General Sales Tax Deduction Worksheet		(Keep for Your Records)	
(Using the Optional State Sales Tax Tables)		1. <u>1611</u>	
1. State general sales taxes. See Step 1 through Step 3 above			
2a. Local general sales tax rate. If zero, skip lines 2a through 2c, enter -0- on line 2d, and go to line 3	2a. <u>.025</u>		
2b. State general sales tax rate	2b. <u>.0625</u>		
2c. Divide line 2a by line 2b. Enter the result as a decimal (rounded to at least three places)	2c. <u>.4</u>		
2d. Local general sales taxes. Multiply line 1 by line 2c		2d. <u>644.40</u>	
3. General sales taxes paid on specified items, if any. See Step 5 above		3. <u>2625</u>	
4. Deduction for general sales taxes. Add lines 1, 2d, and 3. Enter the result here and on Schedule A (Form 1040), line 5, and be sure to check box b on that line		4. <u>4880.40</u>	

Note. If you elect to deduct general sales taxes, you cannot deduct your state and local income taxes.

nois family would divide \$1,611 by 25. The result—\$25,776—represents what the IRS expects an average family of four with \$120,000 of adjusted income to have spent in 2004, including big-ticket purchases. If this family spends more, it's likely to net a sales tax deduction on its 2005 rebooked actual expenditures.

I moved?

to a combined sales tax deduction covering the states you lived in. Say you spent the first 250 days of 2004 in Illinois. Start with the \$1,611 Illinois deduction. Then, multiply by the portion of the year you lived in Illinois—or 250 days divided by the 366 days in 2004. The result, \$1,100, is the Illinois sales tax you can claim. Repeat this exercise with other states you lived in, and add the results to get your total deduction.

Computing the alternative minimum tax, how is the new deduction?

In the case with the state and local income tax deduction, the AMT wipes out the sales tax deduction, says Martin Nisim, national director of personal tax planning at Ernst & Young.

Purchases qualify?

Some states levy special taxes on purchases such as hotel rooms and restaurant meals that generally aren't deductible, CCH's Logan says. But if in those states you pay different rates on clothing, medical supplies, and vehicles, you can still generally claim a deduction for the amount you paid, says William Massey, senior tax advisor at tax information provider RIA.

In a state with a high income tax, should I bother doing the math?

In some situations, you still might do the math with the sales tax. If you have a lot of free municipal bond income, you may pay so little in income tax that the sales tax deduction is the better alternative, says Alfred Peguero, partner at WaterhouseCoopers. If this was a case of big purchases, you may also want to go ahead by deducting sales taxes. In doubt, do the numbers. ■

Move Over, Internet Explorer

Why the rush to Firefox? It's easy to use and more secure than Microsoft's browser. **BY STEVE HAMM**

A NEW WEB BROWSER is catching fire—the aptly named Firefox. It's rapidly becoming the browser of choice for PC users who are concerned about the security of Microsoft's ubiquitous Internet Explorer, a favorite target of viruses and spyware programs.

Firefox has some nifty features that Internet Explorer lacks, and it runs on Linux computers as well as Windows and Mac machines. It also appeals to people who don't want Microsoft to monopolize the Web.

If you haven't made the switch to Firefox, getting started is a snap. Using your current browser, go to Mozilla.org and click on the Firefox download button. When a window opens asking you what you want to do with the file, click "save to disk." Then, when the computer displays a download manager list, click on the "Firefox setup" item. A setup wizard walks you through the process.

SWIFT AND SVELTE

AT THE END YOU have the opportunity to select Firefox as your default browser. If you do, you can still use the other browsers on your computer. With a last click you can import favorites, bookmarks, passwords, and cookies from your previous browser. The whole process takes two minutes if you have a broadband connection.

One of the pluses of Firefox is that it is a svelte program that loads and operates

quickly. The "Firefox Start" page has a Google search bar in the middle and easy-to-identify menus and links to familiar browsing features. Click first on the "Firefox Help" link at the bottom left, which takes you to "Firefox Central," a page that explains how to use the program. Firefox makes it easy to add plug-ins such as Real Player for stream-

ing media and Java for interactivity. You can also add extensions that provide optional features such as chat and a dictionary.

One of the most popular standard features is "tabbed browsing." This allows you to set up a handful of favorite Web pages that open automati-

cally when you launch your browser. You can keep your A-list pages open and shift rapidly among them using graphical tabs that look similar to those on paper file folders.

Unfortunately, some Web sites use proprietary Microsoft technologies that are not fully compatible with Firefox. In most cases you can still use the sites, but some of the graphics may be distorted. The Mozilla Foundation, which built Firefox with the help of thousands of volunteer programmers, has organized a campaign to persuade Web sites to adopt open standards and welcome all browsers.

One last to-do item before you start surfing with Firefox: Take a minute on the Mozilla.org site to make an online donation to the foundation, whose mission is to preserve choice and innovation on the Internet. The browser is free, but Mozilla has expenses. If you're using the product, why not help support it? ■

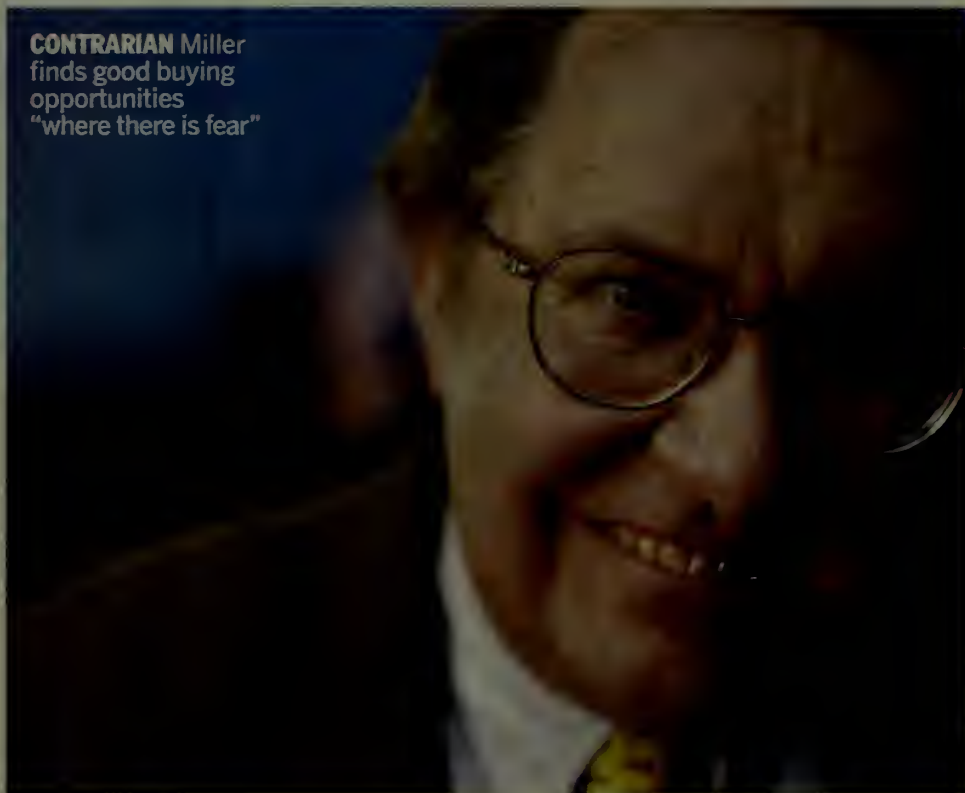


SPREADING FAST
Firefox works with Linux, Mac, and Windows

Investing With Style—Any Style

Bill Miller's lesser-known fund at Legg Mason gives him plenty of ways to beat the market

CONTRARIAN Miller finds good buying opportunities "where there is fear"



BILL MILLER HAS A RECORD unmatched in mutual funds. His Legg Mason Value Trust has trumped the Standard & Poor's 500-stock index in each of the past 14 calendar years. But Miller's lesser-known portfolio, Legg Mason Opportunity Trust, is the more interesting investment vehicle. Unlike the \$17.2 billion Value fund, which focuses on big, often out-of-favor stocks, the \$3.8 billion Opportunity fund has wide berth to buy almost anything and it's as close to a hedge fund as a mutual fund can get. Over the past five years the no-load fund has posted

annualized returns of 8.7%, compared with 2.0% for Value and -2.7% for the S&P 500. The expense ratio is 1.9%. *BusinessWeek* Chicago correspondent Adrienne Carter spoke with Miller about this unusual fund.

What distinguishes Legg Mason Opportunity?

This fund has the ability to do just about anything that regulation allows. It can own large, small, international, or domestic stocks. It can be short. It can be

long. It can own currencies. To a extent, it's experimental because the things we're trying to do is work theoretical concepts.

What theories have you put into practice? Malcolm Gladwell has a new book called *Blink: The Power of Thinking Without Thinking*. Part of the argument is that quick judgments can be as good as judgments arrived at after a lot of work and careful analysis.

How is this applied in the stock market? Career Education Corp. came under pressure in part because of accusations about enrollment figures being inflated. The stock collapsed from around \$30, while its competitors continued to trade at high valuations. I've seen enough of these situations and saw that there was an opportunity here. We were able to act faster than we would have in other circumstances.

So you like to buy controversial stocks? A lot of the stuff we're interested in is to be where there is fear, where people perceive there is a one-way bet.

Are there any one-way bets now?

Everyone thinks the dollar is going to fall. They think they can all make money by shorting the dollar. I'm not playing a rising market today, but I wouldn't rule it out. One thing I like is to own European exporters—which are penalized when the dollar goes down and benefit when it goes up.

The fund has a 3% stake in hedge funds. What's the strategy behind that move?

We own positions in three hedge funds: Omega Capital Partners, Arian Capital Partners I, and Hygrove Capital One. One reason is that these portfolios are long and short, so they've been more volatile than the overall fund while adding value.

Are there challenges in running this fund?

One thing the fund brings out is that the current regulatory environment is not sufficiently flexible. For example, this fund has many of the powers of a hedge fund, but it's relatively unconstrained whenever we try to do something out of the ordinary—like short-sell something we considered doing when it was priced in the mid-50s—we run into regulatory roadblocks that have been navigated by an army of lawyers between the time I make that type of decision and try to implement it, the drops, and we miss the opportunity.

ED BY TODDI GUTNER

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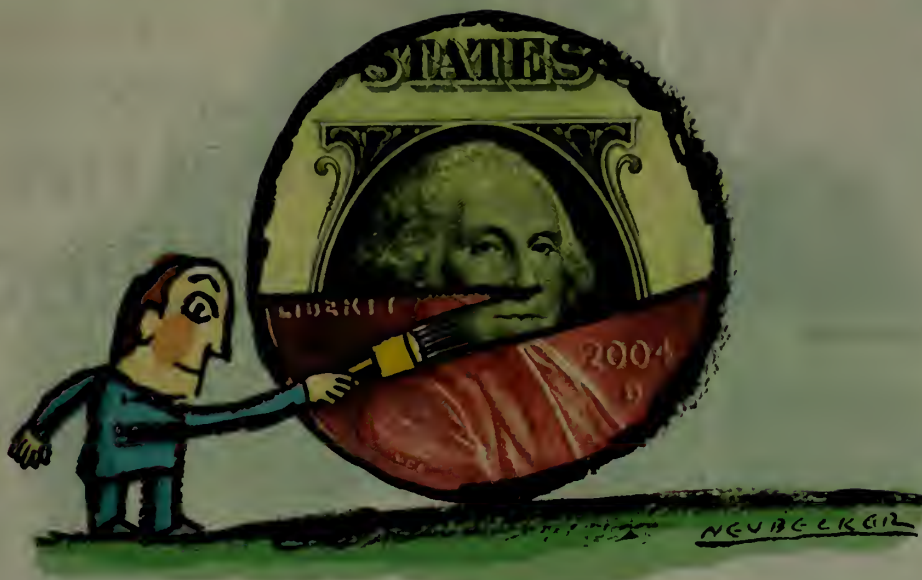
OVERS, pass up the Parmigiano
to, please. Instead, if you haven't
already, you might want to try
Grana Padano, an Italian hard
cheese that's similar in taste and
texture to Parmigiano but not as
famous in the U.S.

Grana cheese comes from five regions of
northern Italy along the Po River.
The word "Parmigiano" derives from the word for
"parma," and Padano refers to the Po
River valley. One reason we're seeing
it in the U.S.: Producers have
undergone a decade-long modernization
process that has allowed them to increase
output while staying true to the
traditional making techniques originated by
medieval Italian monks.

Compared with Parmigiano, Grana
Padano is aged

for a
time
usually 12 to 18
months, vs. 24
months or more)
It costs about
the same (vs.
about \$1 up). It is
made from
skim milk
and it is
not a fat.

—Amy Cortese



BANKING

CDs Unlocked

WHEN BANKS GET FANCY with plain-vanilla products, you know something's up—and right now that something is interest rates. To combat consumer fears about being locked into a low rate, banks are promoting "liquid" and "bump up" certificates of deposit that offer penalty-free withdrawals or the ability to exploit a rise in rates.

Products such as **Bank of America's** 30-month, \$10,000 minimum "Opt-Up" CD let savers hike their rate one or two times over the CD's term (its annual percentage yield, or APY, is 3.3%). "Liquid" CDs like Washington Mutual's five-month CD let depositors with a \$5,000 balance withdraw penalty-free, within limits. The trade-off is often a lower APY. The yield on WaMu's traditional five-month CD, for instance, ranges from 1.5% to 2.45%, vs. 1.29% to 2.37% for a liquid CD. Look for promotions—WaMu recently paid 2.3% for new money going into liquid CDs in some markets.

Is the flexibility worth it? Many people probably don't use the options, says Bankrate.com's Greg McBride. He suggests buying regular 3-, 6-, 9-, and 12-month CDs. If rates rise, reinvest your shortest CD at a higher rate.

—Suzanne Woolley

TESTING

ODS OF rising interest rates, like the one we are in now, are
anxiety-producing for fixed-income investors. Looking
over how different types of bonds have behaved can help
investors make wiser choices. For example, high-yield bonds,
which correlate more with the stock market than the bond
market, have fared better than Treasuries and investment-grade
bonds when rates have gone up in the past.

PERIOD	10-YEAR TREASURY YIELD		AVERAGE ANNUALIZED RETURNS		
	START	END	INVESTMENT- GRADE BONDS	HIGH-YIELD BONDS	LONG-TERM TREASURY BONDS
1983, to June 30, 1984	10.2%	13.9%	0.3%	(1.1)%	(8.3)%
1986, to Sept. 30, 1987	6.4	9.6	(0.7)	6.3	(10.5)
1993, to Nov. 30, 1994	5.4	7.9	(3.6)	0.4	(10.3)
2000, to Jan. 31, 2000	4.4	6.7	(0.6)	4.2	(6.3)

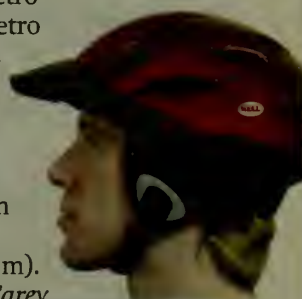
Data: T. Rowe Price Associates

BICYCLING

HOT HEADS

BICYCLE RIDING in the winter typically involves cramming a hat between head and helmet. The combination rarely fits well or feels warm enough. **Bell Sports** solves the problem with accessories that attach to its \$70 Metro helmet. The \$25 Metro Winter Kit includes a set of insulated earflaps and vent plugs to block cold air from flowing through the holes in the helmet (bellbikelhelmets.com).

—John Carey





BY ROBERT BARKER

Still Sweet on Dividend Stocks

For the creditor class, people who count on drawing income from their bond portfolios, the Federal Reserve's steady hikes in short-term interest rates are welcome. As far as they go. Still under 3%, the yields on five-year, AAA-rated municipal bonds won't be funding many ocean cruises this winter.

That's why I've been keeping my eye on an alternative: dividend-paying stocks. In January, 2003, just after President George Bush declared his plan to ease taxation of dividends, I set out to put together a solid portfolio of dividend payers (BW, Jan. 27, 2003). Since then, its seven stocks returned 27%, with dividends reinvested. That's not the 31% delivered by the Standard & Poor's 500-stock index over the stretch, but it easily beat bonds and money funds. After Washington did in fact cut taxes on most dividends to 15%, I assembled a second portfolio of nine dividend-paying stocks (BW, Sept. 29, 2003). It did even better, a return of almost 34%, vs. the S&P's 14%.

TRUST ME, RETURNS THIS BOUNTIFUL came as a surprise, and I don't expect an encore given how interest in dividend stocks has grown. Morningstar just launched a newsletter, *DividendInvestor*, while the virtues of dividends is a main theme of *The Future for Investors*, the latest book by Wharton School finance professor Jeremy Siegel. Just the same, until interest rates have moved considerably higher, I remain

intrigued by the possibilities of gaining more income on a portfolio of relatively stable stocks than with bonds, which are threatened by inflation and higher rates. A typical intermediate-term muni bond fund would see its portfolio fall 5% for each percentage point rise in rates.

So, working with an S&P database that's sold to financial advisers, I searched for stocks with market values of \$3 billion or more and dividend yields between 3.7% and 6%. (The lower number is a bit more than the yield on a five-year Treasury bond; beyond 6% could be a warning of a dividend cut ahead.) I excluded real estate investment trusts, limited partnerships, and foreign stocks, because they generally fall under different tax rules. Finally, I asked the database to return the names only of those stocks that S&P has deemed above average for the stability of their earnings and dividends. Result: 20 names, most of them familiar.

Among them, I next looked for expectations of profit growth and diversification by industry and settled on eight (table): three financials, three utilities (each in a different region), one food, and one drug stock. The latter, Merck, is the most controversial choice, given its declining sales and legal liabilities over the recall of Vioxx. Yet its high research spending may be the source of future cash flow while dividend payments have run under 39% of operating cash flow. At Bristol-Myers Squibb, which I passed over for Merck, dividends have eaten 65% of cash flow. ConAgra Foods, which returned 25% since I included it in the January 2003 portfolio, also made the cut. It's now on such commodity lines as fresh meats, so high-margin packaged foods make up 83% of sales. Just one of the stocks in my 2003 income portfolios, Russ Berrie, had a negative total return of 0.6%. To expect such good fortune again would be foolish. Yet these eight stocks as a group have been relatively stable, suffering just 25% of the S&P 500's volatility. They yield an average of 4.4%, which after a 15% tax leaves 3.7%. That won't make you rich, but it does raise a question: What have your bonds done for you lately? ■



RICH Food
ConAgra Foods returned 25% since January 2003.

Want Income?

COMPANY (SYMBOL)	PRICE	YIELD	COMMENT
AmSouth Bancorp (ASO)	\$24.84	4.0%	Raised payout 34 straight years
Ameren (AEE)	50.01	5.1	Midwest utility renews profit growth
Bank of America (BAC)	45.22	4.0	Top-yielding megabank
ConAgra Foods (CAG)	29.65	3.7	Aiming for less volatile results
Merck (MRK)	29.85	5.1	Payout eats just 39% of cash flow
Pinnacle West Capital (PNW)	42.58	4.5	Arizona's largest utility
Southern (SO)	33.33	4.3	Highly stable electric utility
Washington Mutual (WM)	41.17	4.4	No. 1 savings bank keeps growing

Data: Company reports; Standard & Poor's Business Week

BY GENE G. MARCIAL

THE MARKET IS BOOMING FOR DIAGNOSTIC TESTS FROM **BIOSITE**.

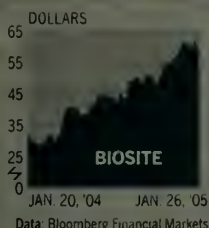
TINY **ARROWHEAD** HAS A TIE-IN WITH CALTECH'S NANOTECHIES.

WITH NEW NONFOOD AISLES, **KROGER** STARTS TO APE WAL-MART.

Biosite's Robust Health

BIOSITE (BSTE) IS A LITTLE-KNOWN diagnostics outfit whose shares are dynamite—blasting from 27 last February to 59.07 on Jan. 26. “It was our top performer,” says Rodney Hathaway of Heartland Advisors, which to sell any of its shares, bought Biosite’s tests are used in 50% of hospitals—and overseas—mainly for heart attacks. Biosite “serves a market with strong growth prospects,” says Hathaway. Driving the rise is Biosite’s 70% share of the market for so-called BNP blood tests for heart failure. Results are available within minutes. Despite the huge gains, he adds, it has room to grow—more than 70 in a year. He estimates the company earning \$2.34 a share in 2004, \$2.50 in 2005, and \$3.20 in 2006, up from 2003’s \$1.50.

IT DOUBLED IN UNDER A YEAR



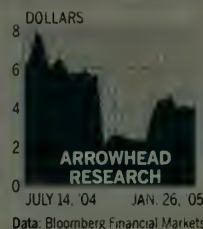
A fresh catalyst for Biosite: a new test, Triage Stroke, to be used along with CT scans for quick diagnosis of heart ischemia, or strokes. Biosite has asked for Food & Drug Administration approval to market it. The FDA could rule on application by yearend. Hathaway says there is an “urgent need for a fast and effective test for strokes. Theodore K. Wachovia Securities, noting Biosite’s “healthy pipeline and strong prospects to beat earnings estimates in 2005,” rates the stock “outperform.”

Arrowhead May Shoot the Nanotechs

NANOTECHNOLOGY, which involves the design of materials or devices at the molecular level, hasn’t produced many big winners. One stellar performer, however, has been tiny Arrowhead Research (ARWR), which other stocks in the Merrill Lynch nanotech index. It rose from 1.95 in January, 2004, to 4.32 on Dec. 31. The stock—not for the faint of heart—is now at 3.96. The index is made up of 27 nanotech stocks traded in the U.S., has risen since its Apr. 1 launch. Arrowhead signed a pact in 2004 with California Institute of Technology to fund its nanotech research in exchange for the rights to future products. Karsten Siebert of Midas Research on Arrowhead, which has yet to make a dime, a “speculative” company could be the “wild card” among the

nanotechs because of its close ties with Caltech, Siebert says. The analyst sees the stock hitting 6 in year. Arrowhead President Bruce Stewart says one product apt to hit the market late this year is an atomic force microscope probe, 1,000 times as sensitive as the existing ones. It lets scientists image and manipulate molecules and atoms in nano dimensions.

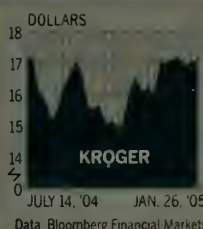
A SMART BOUNCEBACK



Shopping at Kroger —For Toys and Furniture

KROGER (KR), No. 1 in U.S. grocery-chain sales, with 2,500 supermarkets in 32 states, is taking a leaf from the book of its nemesis, Wal-Mart Stores. Starting with 23 outlets (in Arizona, Ohio, and Utah), it is adding higher-margin nonfoods, such as toys, furniture, and bedding. Kroger has suffered from Wal-Mart’s incursion into the food business. Now, Kroger is on a “fundamental turnaround,” says Scott Kuensell of Brandywine Asset Management, which owns stock. He notes that Kroger is starting to raise grocery prices and fatten margins, which shrank during Kroger’s former price-cutting. Its stock—stuck since August between 15 and 17, where it is now—has been stymied by a strike in Southern California (now settled) and fierce competition. The stock is a bargain, says Kuensell, trading at just 12.5 times his 2006 earnings forecast of \$1.35 a share, up from 2005’s estimated \$1.11 and 2004’s 42¢. His 12-month target is 25. Kuensell says Kroger is likely to beat analysts’ estimates. According to Zacks Investment Research, the 2006 mean estimate is \$1.25. John Heinbockel of Goldman Sachs, which has done banking for Kroger, says nonfoods, which are boosting sales, hold growth potential for Kroger, which “remains our preferred food retail investment.” He rates the stock “outperform.” ■

NOT BULKING UP JUST YET



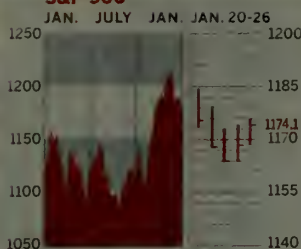
BusinessWeek online

Gene Marcial’s Inside Wall Street is posted at businessweek.com/today.htm at 5 p.m. EST on the magazine’s publication day, usually Thursdays.

Note: Unless otherwise noted, neither the sources cited in Inside Wall Street nor their firms hold positions in the stocks under discussion. Similarly, they have no investment banking or other financial relationships with them.

STOCKS

S&P 500



COMMENTARY

Although earnings from such bellwether outfits as GE came in higher than expected, markets declined, in part due to worries about low oil inventories. Energy concerns were up, however, and stocks rallied at the end of the week, almost managing to climb out of their hole. For the week, the Dow, the S&P 500, and NASDAQ lost 0.4%, 0.9%, and 1.3%, respectively.

Data: Bloomberg Financial Markets, Reuters

U.S. MARKETS

	JAN. 26	WEEK	% CHANGE YEAR TO DATE	LAST 12 MONTHS
S&P 500	1174.1	-0.9	-3.1	1.6
Dow Jones Industrials	10,498.6	-0.4	-2.6	-1.9
NASDAQ Composite	2046.1	-1.3	-5.9	-5.0
S&P MidCap 400	637.6	-0.4	-3.9	5.8
S&P SmallCap 600	316.2	0.3	-3.8	10.3
DJ Wilshire 5000	11,544.4	-0.8	-3.4	2.3

SECTORS

	JAN. 26	WEEK	% CHANGE YEAR TO DATE	LAST 12 MONTHS
BusinessWeek 50*	690.3	-1.2	11.0	8.8
BW Info Tech 100**	352.5	-1.4	0.6	-5.2
S&P/BARRA Growth	564.8	-1.0	-3.0	-2.2
S&P/BARRA Value	605.0	-0.7	-3.3	5.4
S&P Energy	294.4	1.4	2.0	26.8
S&P Financials	399.2	-0.8	-2.9	0.5
S&P REIT	133.0	-3.4	-8.0	12.3
S&P Transportation	219.9	-0.7	-8.9	10.3
S&P Utilities	141.9	0.9	0.2	17.9
GSTI Internet	165.4	-2.2	-7.2	4.4
PSE Technology	731.0	-1.0	-6.2	-2.5

*Mar. 19, 1999=1000 **Feb. 7, 2000=1000

GLOBAL MARKETS

	JAN. 26	WEEK	% CHANGE YEAR TO DATE
S&P Euro Plus (U.S. Dollar)	1348.1	-0.3	-3.5
London (FT-SE 100)	4847.1	0.6	0.7
Paris (CAC 40)	3879.8	0.3	1.5
Frankfurt (DAX)	4214.1	-0.7	-1.0
Tokyo (NIKKEI 225)	11,376.6	-0.3	-1.0
Hong Kong (Hang Seng)	13,623.7	-0.4	-4.3
Toronto (S&P/TSX Composite)	9162.4	0.5	-0.9
Mexico City (IPC)	13,045.1	0.1	1.0

FUNDAMENTALS

	JAN. 25	WEEK AGO
S&P 500 Dividend Yield	1.99%	1.94%
S&P 500 P/E Ratio (Trailing 12 mos.)	19.5	20.2
S&P 500 P/E Ratio (Next 12 mos.)*	15.9	16.2
First Call Earnings Surprise*	2.61%	4.02%

TECHNICAL INDICATORS

	JAN. 25	WEEK AGO
S&P 500 200-day average	1133.9	1133.4
Stocks above 200-day average	68.0%	75.0%
Options: Put/call ratio	0.79	0.69
Insiders: Vickers NYSE Sell/buy ratio	5.09	5.35

BEST-PERFORMING GROUPS

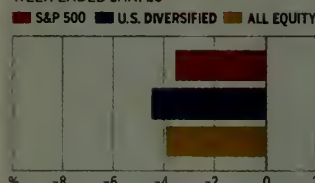
	LAST MONTH %		LAST 12 MONTHS %
Drug Chains	6.2	Fertilizers & Ag. Chems.	74.0
Health-Care Facilities	6.1	Steel	65.9
Homebuilding	4.4	Oil & Gas Refining	51.4
Oil & Gas Refining	3.7	Managed Health Care	47.7
Housewares & Specfts.	3.4	Internet Software	47.3

WORST-PERFORMING GROUPS

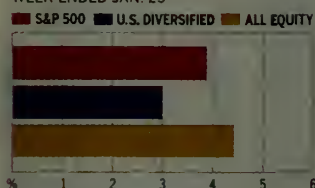
	LAST MONTH %		LAST 12 MONTHS %
Internet Retail	-27.4	IT Consulting	
IT Consulting	-22.8	Semiconductor Equip.	
Communication Equipment	-11.5	Insurance Brokers	
Air Freight & Couriers	-10.8	Electric Mfg. Svcs.	
Airlines	-10.4	Semiconductors	

MUTUAL FUNDS

4-WEEK TOTAL RETURN



52-WEEK TOTAL RETURN



Data: Standard & Poor's

EQUITY FUND CATEGORIES

4-WEEK TOTAL RETURN	%	52-WEEK TOTAL RETURN	%
LEADERS		LEADERS	
Natural Resources	0.1	Natural Resources	26.1
Pacific/Asia ex-Japan	-0.5	Latin America	22.6
Diversified Emerg. Mkts.	-0.6	Real Estate	19.2
Diversified Pacific/Asia	-0.8	Utilities	17.9
LAGGARDS		LAGGARDS	
Technology	-9.0	Technology	-12.6
Small-cap Growth	-6.7	Precious Metals	-6.6
Real Estate	-6.2	Small-cap Growth	-2.8
Communications	-6.0	Large-cap Growth	-0.6

EQUITY FUNDS

4-WEEK TOTAL RETURN	%	52-WEEK TOTAL RETURN	%
LEADERS		LEADERS	
Rydex Dyn. Vent. 100 H	18.6	iShares MSCI Austria Idx.	48.2
ProFunds UltSh. OTC Inv.	18.5	State St. Rsch. Rscls. A	44.5
ProFds. Ush. Sm. Cap Inv.	16.2	Metzler/Pdn. Eur. Em. Mkt.	43.4
Oppenheimer RI. Asst. A	11.3	Morgan. St. Eur. R. Est. A	41.9
LAGGARDS		LAGGARDS	
ProFds. Intnet. Ultsr. Inv.	-19.0	Ameritor Investment	-45.7
Apex Mid Cap Growth	-18.1	ProFunds Semicdr. Inv.	-44.9
ProFunds UltraOTC Inv.	-16.2	Van Wagoner Sm. Cap. Gr.	-36.5
Rydex Dyn. Veloc. 100 H	-16.2	Apex Mid Cap Growth	-34.7

INTEREST RATES

KEY RATES

	JAN. 26	WEEK AGO
Money Market Funds	1.85%	1.81
90-Day Treasury Bills	2.41	2.36
2-Year Treasury Notes	3.25	3.22
10-Year Treasury Notes	4.19	4.18
30-Year Treasury Bonds	4.66	4.66
30-Year Fixed Mortgage †	5.59	5.61

†Bank

BLOOMBERG MUNI YIELD EQUIVALENTS

Taxable equivalent yields on AAA-rated, tax-exempt municipal bonds, assuming a 30% federal tax rate.

	10-YR BOND	30
General Obligations	3.58	
Taxable Equivalent	5.11	
Insured Revenue Bonds	3.71	
Taxable Equivalent	5.30	

THE WEEK AHEAD

NEW HOME SALES Monday, Jan. 31, 8:30 a.m. EST » New homes probably sold at an annual rate of 1.2 million in December, up from 1.12 million in November. That's the median forecast of economists surveyed by Action Economics LLC.

FOMC MEETING Tuesday, Feb. 1, 9 a.m. EST » The Federal Reserve's Open Market Committee begins its two-day meeting to set monetary policy. In the Action poll,

economists were unanimous in forecasting a quarter-point hike in the federal funds rate, to 2.5%.

PURCHASING MANAGERS' INDEX Tuesday, Feb. 1, 10 a.m. EST »

The Institute for Supply Management's manufacturing index probably dipped to 58% in January from 58.6% in December.

PRODUCTIVITY & COSTS

Thursday, Feb. 3, 8:30 a.m. EST » Output per hour worked probably grew at a 1.9% annual rate

in the fourth quarter compared with the third, when it rose at a 1.8% pace. Unit labor costs very likely also grew by 1.9% last quarter, on top of a 1.8% rise in the third.

EMPLOYMENT Friday, Feb. 4, 8:30 a.m. EST » The Action Economics survey calls for a gain of 180,000 new nonfarm jobs in January, better than the 157,000 positions created in December. The unemployment rate is expected to remain at 5.4%.

The *BusinessWeek* productivity index increased 0.5% in the week Jan. 15 and stood 12.3% above a year-ago reading. Before the index fell again, to 240.1 from

BusinessWeek online

For the BW50, more investment data, and the components of the production index visit www.businessweek.com/magazine/est

Companies

Index gives the starting page for a story or feature with significant reference to a company. Most subsidiaries listed under their own names. Companies listed only as subsidiaries are not included.

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The Counterfeit Catastrophe

FROM THE BARBARY pirates to the rumrunners of Prohibition to today's e-mail spammers, every period has its distinctive form of economic criminal: people who flout or break the rules of commerce for their own benefit. Such problems can't be eliminated, but a successful society keeps them under control.

By that measure, the era of globalization may be facing one of its biggest challenges. The astonishing expansion of manufacturing capabilities in less developed countries, notably China, has raised incomes and boosted trade around the world. But the same production and distribution also have created a frightening phenomenon: an ever-rising flood of counterfeits and fakes coming onto world markets (page 54).

These days it's far more than Rolex watches. As factories in China and elsewhere gain experience with high-end manufacturing, counterfeits have become more sophisticated as well. Auto parts, pharmaceuticals, high-end golf clubs, cell-phone batteries, PlayStation controllers, motorcycles: If it can be made, it can be faked—and fast. By one estimate, counterfeiting now accounts for 5% to 7% of

world trade. Soon profit margins may be in serious peril. The global economy is at a critical juncture. If the economic criminals are left unchecked, they will undermine the reasons for investing in new products and new brands. Why should Yamaha put the money into developing a new line of motorcycles if they will be copied as soon as they hit the streets?

Curbing piracy is as urgent as taking down trade barriers

That's why a crackdown on counterfeiting—or, as the trade negotiators put it, the protection of intellectual property—has to be moved to the top of the trade agenda. In a global economy driven by innovation, protecting new products and technologies from pirates is more important than pulling down the few remaining trade barriers. A report from the Council on Competitiveness got it right

it said “there must be an international rule of law that supports global innovation.”

It's encouraging that Chinese authorities, long unconcerned about counterfeiting, have begun to realize that their own growing corporations are getting just as vulnerable. As Chinese companies create brands and intellectual property, they may pressure Beijing to act against counterfeiters.

If China starts lowering its tolerance for piracy, that will be a sign that it is starting to see itself as a major economic power, not a poor nation. Then and only then will globalization be safe from this kind of pervasive economic corrosion.

How to Rewire The FCC

IS THE U.S. TELECOM industry sprinting or inching into the future? Sometimes it's hard to tell. Telecom companies and equipment providers seem to announce bold new initiatives and cutting-edge technologies every day. Yet key problems—including getting fast broadband connections to the majority of American homes and ensuring enough competition in local phone and cable markets—still elude solution.

Michael K. Powell's decision to step down as chairman of the Federal Communications Commission offers an opportunity to think about how we can do better (page 34). Powell, appointed to the FCC by Bill Clinton in 1997 and named chairman by George W. Bush in 2001, was a true technological determinist. His vision was that technology would provide high-capacity connections to the home—either wired or wireless—and

generate enough competition without the heavy hand of regulation. In that sense, he was on the right side of history.

But change didn't happen as fast as Powell expected. He was too quick to abandon regulation before the technologies had developed enough to create new competition. Take Powell's move to allow one company to own broadcast stations and newspapers in the same market. In theory, such consolidation is O.K., since there are plenty of Internet and cable-news providers. However, in practice, people still mainly get their news from the local paper and local TV station.

Similarly, Powell's reliance on market and technological forces to bring broadband to the home has turned out to be overly optimistic. Progress has been too slow, with broadband penetration in the U.S. lagging many other countries. That's why competition may need a push. Powell's successor will have to consider, for example, pressuring TV broadcasters to surrender some of the extra frequencies they have been hoarding. That would free up more spectrum for wireless broadband, a potentially inexpensive way to get fast Internet service into more homes. The next chairman will also have to revisit the question of whether a subsidy, funded by a user fee, could help the broadband rollout, especially in rural areas.

Deregulation is good, and so is technology. But running U.S. telecom policy requires appreciating when a bit of regulation can be a positive thing. That's something Powell never seemed to understand.

s Week

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down to the level of
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By Stephen Baker and Adam Aston

**“WE DIDN’T BUILD THIS
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IT JUST KINDA GREW.”**



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FRIDAY AUGUST 29, 2003 - VOL. CCLXII NO. 43 - ***** \$7.00

When it came to our tasting of "white goods," the superpremiums ruled the day. Here, our top three in each category, plus our tasters' comments:

LIQUOR BRAND/PRICE* OUR AWARD

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Microsoft's Golden Halo Is Gleaming Again

Fiscal 2005 was supposed to be one of the slowest in its history. But second-quarter results defied naysayers and the company's own expectations, thanks to server software, PCs, and the hit game *Halo 2*

Beware the Beige-Box Blahs

BusinessWeek Online Technology channel columnist Nicholas Carr argues that PC giant Dell shouldn't dismiss Apple's design-driven success. Markets historically evolve past commoditization to value style and special features

Why the World Economic Forum Is Worth the Effort

Beyond rubbing elbows with celebs and Presidents, the real thrill is the feeling of optimism at this elite global confab. Plus: Decoding China's yuan messages, and fresh air in the Middle East

A Big Score for SAT Tutors

Parents' and students' worries about the revamped college-entrance exam are boosting test-preparation companies such as Kaplan and Princeton Review. When the panic eases, can they still make the grade?

RFID Tags: Plenty of Mixed Signals

Despite Wal-Mart's push for radio-frequency identification, skeptical suppliers are still foolishly slow to embrace the new technology

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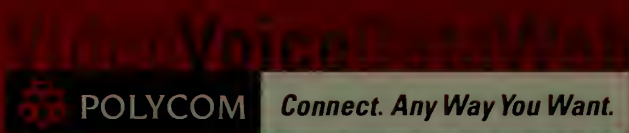


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UP Front

"The ol' dollar
—it's gonna
go down."

—Bill Gates, in a
Jan. 28 interview
with Charlie Rose on
recent currency
fluctuations and
shorting the dollar

BY IRA SAGER

SECOND ACTS

GIGGED BY OUT AOL

LEAVING executive posts
America Online in 2002,
Colburn and Myer
have resurfaced at
phone company in

affairs unit, and Berlow, ex-
president of AOL's interactive
marketing unit, cut many of
those deals. Neither has been
named in pending federal
investigations. On Dec. 15,
Time Warner entered into a
settlement with Justice and a
tentative settlement with the
SEC, without admitting or
denying wrongdoing.

While Colburn and Berlow

are listed in IDT's
phone directory,
they're not on the
payroll, says an IDT
spokesman. Berlow
says he is not
involved with the
company, but
working on
charities, including
an anti-spouse-
abuse group, with
IDT Chairman
Howard Jonas. He

says he isn't working with
Colburn. The IDT spokesman
was unable to find out what
Colburn is doing. Colburn
did not return calls for
comment. —Catherine Yang

COLBURN AND BERLOW On the fringes at IDT

ark, N.J.
pair left the
e service
the Securities &
ange Commission and
ce Dept. launched
es into the accounts of
s ad deals. Colburn, ex-
dent of AOL's business

THE BIG PICTURE

AT, US WORRY? Do insurance execs feel any
d to change their practices in light of
New York Attorney General Eliot Spitzer's
bes of bid-rigging and fees? Guess not.

AMOUNT OF TIME CURRENTLY SPENT ON COMPLIANCE IS FINE

62%

INVESTIGATIONS HAVE NOT DISRUPTED THE COMPANY

50%

IMPLEMENTING NEW BEST PRACTICES IS NOT NEEDED

45%

Now Technologies survey of 260
insurance executives, December, 2004



BALLMER
He spilled
the beans
in Bombay

CULTURE CLASH

Telling Tales Out of School

IT'S HARD TO BLAME Microsoft Chief Executive Steven Ballmer
for roiling one of India's largest public companies. But it's
hard to ignore his role, either. On Nov. 17, Ballmer gave a
speech to execs in Bombay. All seemed well when Mukesh
Ambani, chairman of petrochemical giant **Reliance Industries**,
introduced his **Stanford University** B-School classmate. Then
Ballmer joked that neither he nor Ambani had the qualifica-
tions to address the group, since neither obtained his MBA.

Dropping out may seem like a small matter in the U.S. But
in India, which puts a premium on education, it's a source of
shame. Ambani had described himself as a graduate from
Stanford—even in annual reports. The company literature now
says Ambani "pursued an MBA from Stanford University."

Ballmer's remark seems to have rattled Ambani. Immediately
after the meeting, Ambani told a local reporter the company
faced "ownership issues," confirming rumors of a rift between
him and younger brother Anil, who co-runs the \$16 billion
Reliance. Since then, the brothers have fought over the family's
33% stake in Reliance, which could lead to a breakup.

Spokesmen for the pair declined comment. And Ballmer?

Now he's not talking. —Manjeet Kripalani, with Jay Greene

FACE TIME

ADRIANE BROWN



DRIVEN TO SUCCEED AT HONEYWELL

Adriane Brown sees her latest appointment as something of a return to her roots. The newly minted chief executive of Honeywell's \$4.3 billion transportation systems unit has always been fascinated by cars. When she was little, she would hang out in the garage and go to car races with her father. At Corning, she worked her way up to run the automotive-products unit. But a few years ago, Brown left that earthbound business to take a management position in Honeywell's aerospace biz.

Now Brown, 46, is back in the automotive business. She says she has big plans for the unit, which makes everything from engine parts to antifreeze. "It's in how you expand," she says. For instance, Honeywell makes turbochargers used to boost car engines that could do the same for train or boat engines. The company's car filtration products could be used in water or cabin air filtration systems, she says. Brown might be back in automotive, but she's looking elsewhere for growth.

—Olga Kharif

TREND WATCH

BEREAVED, BUT NOT BROKE, IN JAPAN

IN JAPAN, few rituals are as tightly scripted as the send-off for the dearly departed. The typical Buddhist-inspired funeral involves a pre-cremation gathering, a memorial service, and a cremation ceremony. Despite the \$22,000 price tag, most grieving families fork over the yen rather than risk being seen as cheapskates.

Now, though, there's another choice. Thanks to a handful of upstart mortuaries, the traditional funeral may go the way of the 39,000-point Nikkei. Tokyo-based **Urban Funes**, for example, offers a service for just \$3,838. Sales in the year through September rose 50%, to \$1.15 million. "The

COSTLY Price competition has arrived

industry is facing radical reform," says

Hajime Himonya, editor of *SOGI*, an industry trade magazine.

The business clearly offers growth dynamics to die for. More than 1 million souls departed for the great beyond in 2003, and that annual tally is expected to increase nearly 50% by 2020.

Discount funeral parlors have injected much-needed

price competition into a billion industry. The ups are forcing change at Japan's 45,000 old-guard funeral purveyors. Some rates have dropped by half, and "many funeral parlors have gone bankrupt from the recent price competition," says Midori Kotani, an industry analyst with **Dai-ichi Life Research Institute**. For Japan's graying seniors—and their families—the trend is welcome.

—Hiroko Tashiro
Brian Br



MAD AVENUE SKIRTING A BAN AT THE SUPER BOWL

BROADCASTER Fox Sports has told Super Bowl advertisers to nix any direct reference to last year's Janet Jackson imbroglio during the half-time show. But Bob Parsons, president of **Go Daddy Group**, a top registrar of Web addresses, has found a way around the ban. He's

spending \$4 million on an ad he hopes will cause a stir. In it, a curvaceous actress goes before a government committee asking approval for a GoDaddy.com ad. She's wearing a top with shoulder

straps, and one of them breaks. Fortunately, she catches it in time. "Maybe it should be PG-rated," says Parsons, with a wink.

Parsons' ad plan harks back to the go-go days of the dot-coms. The difference? Go Daddy has \$102 million in revenue and \$10 million in cash—even after paying Fox. Parsons plans to watch the game at his Scottsdale (Ariz.) office, munching pretzels and waiting for hits to his Web site.

—Steve Hamm

THE STAT

61

The percentage of middle-class Americans who do believe they can count on Social Security to provide them with income for their retirement. Furthermore, 20% say they have yet to even begin planning for the golden years.

Data: NGUSF, 2004 Survey

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UP Front

BANK NOTES

KORAN-FRIENDLY LENDERS

WHO WOULDN'T want an interest-free loan? If you happen to be a devout Muslim, it's the only option. Paying interest—*riba*—is forbidden. That puts would-be homeowners who are Muslim-American in a bind. Saving to pay for a home in full when housing prices are skyrocketing is nearly impossible.

Now Koran-compatible "Islamic banking" is coming to the U.S. Leading the way is **Devon Bank**, a small community bank in Chicago owned by the Loundy family, who are Jewish. In January, **Freddie Mac** agreed to buy Devon's Islamic home financing products, freeing up capital for a national expansion. Devon also is working with **Fannie Mae** to develop Koran-compatible home mortgage products. Other banks are starting to offer Islamic services in the U.S., including the **University Bank** in Ann Arbor and **HSBC** in New York.

Devon, on Chicago's North Side, anchors a neighborhood that has shifted from Eastern European Jews to Indian, Pakistani, and Middle Eastern Muslims. To meet customers' needs, the bank, which has \$261 million in assets, spent two years developing financial products that could conform to Islamic laws and pass the financial scrutiny of U.S. regulators.

Under *Murabaha*, or

installment financing, Devon buys a property chosen by a customer, then turns around and sells it for a price that includes projected interest costs. There is no principal

and thus, technically, no interest. Islamic financing is nearly half of Devon's mortgage portfolio.

The bank also offers Koran-friendly financing for commercial real estate, business equipment, and letters of credit. "We are a community bank helping a community that's being underserved," says David Loundy, the bank's legal counsel. "In this case it's the Muslim community." Given an estimated 6 million Muslims in the U.S., that's bound to change.

—Janet Ginsburg



FINANCING LAW
Paying interest is forbidden

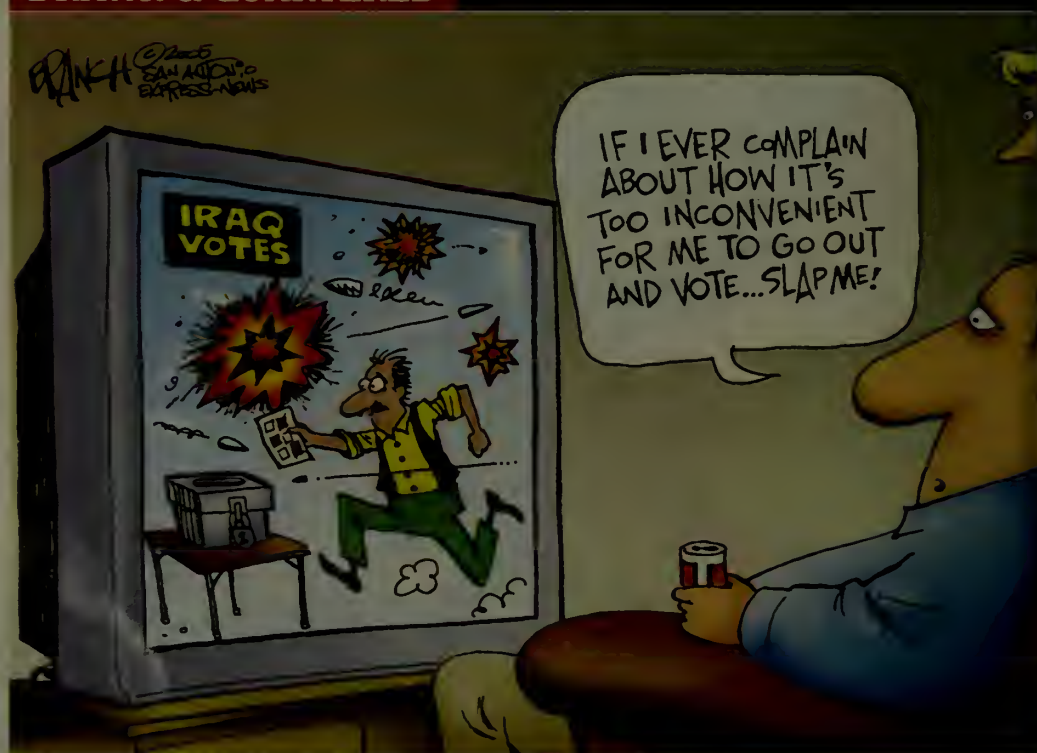


ON TV

TOON TIME Jay Leno and David Letterman taking a beating from a meatball, a milk shake, and an order of fries. Cartoon Network's **Adult Swim**, with programs such as *Aqua Teen Hunger Force*—featuring the three superhero fast-foods—is the top-rated show on late-night in the coveted 18-to-34-year-old male category. The show whips Leno and Letterman in the Nielsen ratings by 26%. Advertisers were skeptical at first, but brands like Toyota, Nokia, and Pizza Hut have seen the light. Adult Swim accounts for 30% of the Time Warner network's total ad revenue.

—Erin Cham

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IN 1822,
**THE
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 DIDN'T STOP KING GEORGE IV
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While on a royal visit to
 KING GEORGE IV
 GREAT BRITAIN called for
 GLENLIVET. It was illegal
 sublime, "MILD AS MILK,"



and he would DRINK
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Social Security is ... designed to keep retired Americans from poverty. It was not envisioned as an investment vehicle."

—Mark A. Brown, CPA
 San Francisco

"Social Security: Are private accounts a good idea?" (Special Report, Jan. 24) generated an outpouring of mail on private accounts as well as many perspectives on the future of Social Security. To see more letters, go to www.businessweek.com/extras.

JUST WHAT IS SOCIAL SECURITY?

SOCIAL SECURITY IS actually the Federal Insurance Contribution Act (FICA), designed to keep retired Americans from poverty. It was not envisioned as an investment vehicle. I don't ask the carrier of my auto insurance to allow me to invest the premiums, nor do I wish to manage my Social Security premiums myself. I have investments of my own I control.

Seen as insurance against poverty, Social Security can be easily adjusted to carry forward for generations without major changes, and without throwing the onus of bad investing on the millions of Americans who are neither market-savvy nor versed in stock market participation.

—Mark A. Brown, CPA
 San Francisco

SINCE MOST OF US are living longer, healthier lives, we should be willing to work longer and continue to pay into the

system. Phasing in benefits calculation price indexing rather than wage indexing would help keep the system solvent at least another 75 years, if economists are to be believed. In the interest of fairness, we need to raise the tax on annual income level to at least \$250,000. And we need to ensure that the system is both fair and progressive, progressive enough to maintain the safety and dignity of impoverished and disabled elderly. Social Security was never meant to subsidize Uncle Mort's green fees and country club in Florida, but Great Aunt Dorothy should not be eating cat food, either.

—Jennifer Grant P

FEDERAL SHELL GAMES

I NOTICED THAT, according to your article, Social Security private investments would earn more than that money currently earns in the Social Security "box." As I see it, the federal government currently gets a cheap loan from Social Security savings, but if we put private account money in mutual funds, the government will have to pay a higher interest rate to attract money from the open market to make up for the \$16

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RECTIONS & CLARIFICATIONS

new banker?" (News: Analysis & Commentary, Feb. 7) should have said that the estimates, about 56 million U.S. dollars, have no bank accounts. And the Mart Money Center shown in the photograph was not one of the bank branches owned by SunTrust.

story on developmental videos for babies, we overestimated the size of the market. ("Brainier babies? Maybe. Bigger? Definitely," News: Analysis & Commentary, Jan. 12, 2004). We believe the market is approximately \$100 million in sales rather than the \$700 million reported.

Why you lost all that money" (Books, Jan. 31), the name of the former AT&T CEO should have been C. Michael Armstrong, not Michael C. Armstrong.

letter from James J. Treacy (Readers Report, Feb. 7) replying to "The future of the New York Times" (Cover Story, Jan. 17), neglected to disclose his former affiliation as president and chief operating officer of P Worldwise (now Monster Worldwide).

per year transition cost. This higher interest rate will then also apply to the \$10 billion annual deficit and will then apply to our \$7.6 trillion debt as we gradually refinance it each time it matures.

short, for every additional dollar we invest in our private accounts, the federal government will be paying an extra dollar in interest on the debt.

—Romona Tung
La Canada-Flintridge, Calif.

MOST REGRESSIVE TAX WE HAVE

TO REDUCE THE TAX RATE to one-half of its current level, but eliminate the ceiling. The Social Security tax is the most regressive we have. By cutting the rate and eliminating the ceiling, people under the current maximum income of \$90,000 would pay a reduced tax. The current maximum dollar contribution won't be reached until an individual reaches \$100,000 in salary.

—Leonard Donofrio, CPA
Alsip, Ill.

THE SURPLUS TO WALL STREET

LET'S MAKE THE COMPROMISE. Forget individual private accounts and all the administrative cost and investment education that go with them. Instead, run

Social Security like a true defined-benefit program. Keep the current, promised benefit structure in place, but instead of putting the current surplus in Treasury IOUs, start putting it in the stock market. The stock market will get a terrific boost, and we avoid all the hassles of costly, small accounts that Wall Street doesn't want anyway.

—Steve Hensley
Des Moines

THE THRIFT SAVINGS PLAN: A MODEL

MY SUGGESTION FOR reducing the financial cost of funding the projected shortfall in Social Security involves taking the \$80 billion annual interest (for the 13 years between 2005 and the projected date—2018—of negative cash flow) to give about \$1.04 trillion and invest it, for Social Security needs, in the same manner as the federal government's Thrift Savings Plan. This very popular plan for federal employees and members of Congress allows a choice of five highly diversified, low-cost mutual funds. In the Thrift Savings Plan, no direct investments in individual stocks are allowed. The higher interest in the mutual funds will grow the amount even more over the 13 years, and the exhaustion of the Social Security funds will be delayed.

—Sol Aisenberg
Natick, Mass.

DISCOURAGE EARLY RETIREMENT

IN 2002 ONLY 21% of workers waited until at least the normal retirement age. As a consequence, the average age of retirement fell from 66.2 in 1960 to 63.6 in 2002. Discouraging rather than encouraging early retirement would fix the problem.

—Andrew Allison
Carmel, Calif.

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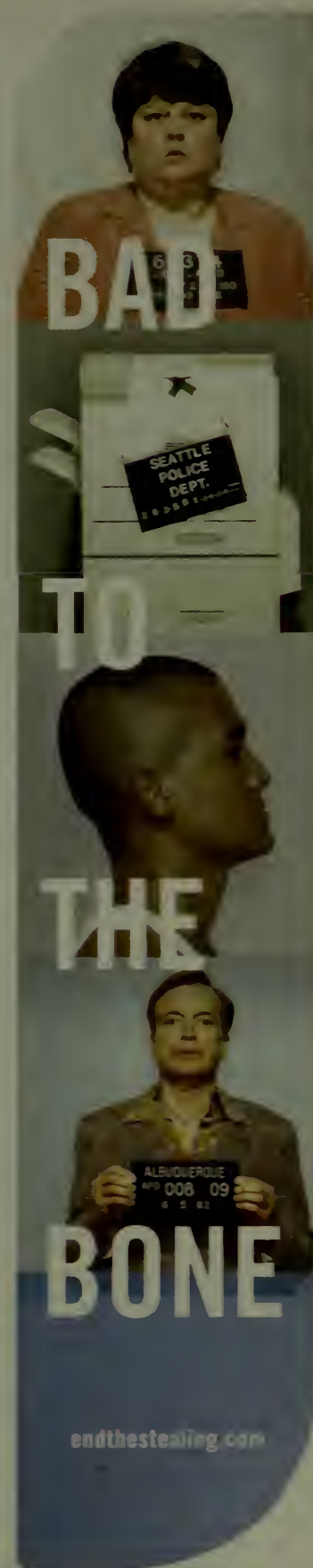
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TOSHIBA

Don't copy. Lead.

Forget the Next Big Thing

THE FUTURE FOR INVESTORS Why the Tried and the True Triumphs Over the Bold and the New
By Jeremy J. Siegel; Crown; 319pp; \$27.50

In 1994, Jeremy J. Siegel, a finance professor at the Wharton School, came out with a new book, *Stocks for the Long Run*. The volume had a powerful theme: Over long enough periods, stocks almost always outperformed bonds. Investors with a 20- or 30-year time horizon should therefore not be

afraid of investing in the stock market.

Stocks for the Long Run was an immediate classic. Now, a decade later, Siegel has written *The Future for Investors*. This volume, which hits the stores on Mar. 8, has an equally provocative thesis: Putting your money into hot technology companies, rapidly expanding sectors, and fast-growing countries is not the best route to investment success.

The "relentless pursuit of growth," writes Siegel, "dooms investors to poor returns." He warns investors not to chase the Next Big Thing. "Technological innovation... turns out to be a double-edged sword that spurs economic growth while repeatedly disappointing investors," concludes Siegel. Investors should instead focus on what he calls the "tried and the true," since "history shows that many of the best-performing investments are... found in shrinking industries and in slower-growing countries."

Siegel offers up a plethora of fascinating facts and insights as he explains why the "tried and true" should outperform the "bold and new." Unfortunately, this book is not nearly as persuasive as Siegel's previous one. His message to investors is undercut by his own analysis, which shows that health care and information technology, both innovative industries, have beaten the overall market during the past half century. Even in the past 10 years—including the boom and bust—investors would have done better putting their money into the info tech sector than into a Standard & Poor's 500-stock index fund.

Despite this failure to prove his main thesis, Siegel's book is still valuable to investors. He points out, for example, that the 900-plus companies added to the S&P 500 index since its creation in 1957 have underperformed the original 500. Initial public offerings also underperform a portfolio of existing small stocks. And he tells why "most capital expenditures provide investors with poor returns."

Siegel gives investors concrete guidance about where to put their money. Rather than only relying on index funds, he recommends using such strategies as focusing on companies with high dividends or low price-earnings multiples. For example, a strategy of holding stocks with high dividends and

reinvesting those dividends serves as protection against a bear market. Why? Because when the stock market goes down, the dividends buy more shares, and there's a chance for a big gain when the market comes back.

Siegel also explains at length how the Baby Boom generation in the U.S., Europe, and Japan will be able to finance its retirement. He does not predict doom, as many do. Rather, Siegel puts his trust in the fast-growing economies of the developing world. "The aging populations will import goods and services they need," he writes, "and finance their purchases by selling their stocks and bonds to the investors in the developing world." In effect, Siegel is expecting Chinese and Indian investors to follow his advice and put their money into the slower-growing countries of the West.

Still, most people will read the book for its treatment of technology investing, and that's where it falls short. Consider

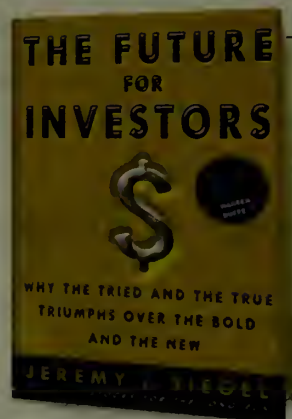
Siegel's claim that investors should be wary of putting money into new technologies. In health care especially—revolutionized by new drugs and surgical techniques during the past 50 years—Siegel writes that "investor excitement had led to higher prices and disappointing returns." Yet his calculations, health-care stocks have generated a 14.2% rate of return since 1957, more than any other sector and way above the 11% rate for the overall S&P. Abbott Labs, Bristol-Myers (later Bristol-Myers Squibb), Merck, Pfizer, and Warner-Lambert (bought up by Pfizer) all turn in annual returns of around 16% or better over the same stretch.

Since 1957, the information technology sector—including both new and existing companies—has produced an 11.4% return, also beating the overall market. Interestingly, people who invested back then in RCA, an early maker of transistors, and held their shares when RCA was bought by General Electric in 1986, would have seen an almost 13% annual return.

From 1994 to today—a period that includes the greatest tech bust in history—the info tech sector has produced annual returns of 13%, compared with 12% for the whole S&P 500 index. The annual return on the health-care sector is almost 15% (these figures include reinvested dividends and are based on data from Bloomberg Financial Markets).

Siegel is one of the most influential figures in modern finance, and well worth reading. But investors should come fortified with a healthy dose of skepticism. ■

—By Michael J. Ma



Siegel's own figures fail to support his anti-tech message



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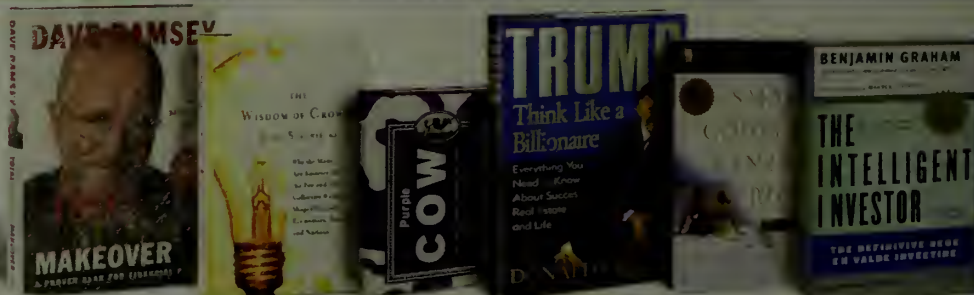
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1	THE AUTOMATIC MILLIONAIRE David Bach (Broadway • \$19.95) <i>How to put your investment program on autopilot.</i>	12	1	SMART COUPLES FINISH RICH David Bach (Broadway • \$14.95) <i>Managing your money after you've walked down the aisle.</i>
2	TRUMP: HOW TO GET RICH Donald J. Trump, with Meredith McIver (Random House • \$21.95) <i>Don't forget to impress the boss.</i>	8	2	SMART WOMEN FINISH RICH David Bach (Broadway • \$14.95) <i>Spending wisely and getting prepared for the future.</i>
3	THE PRESENT Spencer Johnson (Doubleday • \$19.95) <i>The pursuit of happiness and success, described in a fable.</i>	13	3	WHAT COLOR IS YOUR PARACHUTE? Richard Nelson Bolles (Ten Speed • \$17.95) <i>The 2004 edition of the job-search bible.</i>
4	NICE GIRLS DON'T GET THE CORNER OFFICE Lois P. Frankel, PhD (Warner Business • \$19.95) <i>Avoid the lifelong habits that may block promotion.</i>	9	4	TRUMP: THE ART OF THE DEAL Donald J. Trump with Tony Schwartz (Warner • \$6.99) <i>Tax abatements and celebrity-schmoozing.</i>
5	THE WISDOM OF CROWDS James Surowiecki (Doubleday • \$24.95) <i>Group decisions can be better than those of the smartest individual.</i>	4	5	THE ERNST & YOUNG TAX GUIDE 2004 Ernst & Young LLP (Wiley • \$16.95) <i>Get out the 1099s and the W2 forms—and the calculator.</i>
6	THE FRED FACTOR Mark Sanborn (Currency/Doubleday • \$14.95) <i>The mailman's philosophy of work and life.</i>	9	6	EFFECTIVE PHRASES FOR PERFORMANCE APPRAISALS James E. Neal Jr. (Neal Publications • \$10.95) <i>"Attaboy."</i>
7	TRUMP: THINK LIKE A BILLIONAIRE Donald J. Trump, with Meredith McIver (Random House • \$21.95) <i>Tips on real estate, investing—and relationships.</i>	3	7	REAL ESTATE LOOPHOLES Diane Kennedy, CPA, Garrett Sutton, Esq. (Warner • \$16.95) <i>Tax and legal knowhow.</i>
8	CONFIDENCE Rosabeth Moss Kanter (Crown Business • \$27.50) <i>Rising to the occasion, by a Harvard B-school professor.</i>	4	8	THE INTELLIGENT INVESTOR, REVISED EDITION Benjamin Graham, with Jason Zweig (HarperBusiness • \$19.95) <i>The classic explanation of "value investing."</i>
9	HOW FULL IS YOUR BUCKET? Tom Rath, Donald O. Clifton, PhD (Gallup Press • \$19.95) <i>Accentuating the positive at work.</i>	5	9	GETTING THINGS DONE David Allen (Penguin • \$14) <i>Organizing your office and managing your time.</i>
10	THE GREAT UNRAVELING Paul Krugman (Norton • \$25.95) <i>A Princeton University economist vs. the Bush Administration.</i>	7	10	J.K. LASSER'S YOUR INCOME TAX 2004 The J.K. Lasser Institute (Wiley • \$16.95) <i>Home-office deductions, marriage penalties, etc.</i>
11	THE 8TH HABIT Stephen R. Covey (Free Press • \$26) <i>In the new workplace, leaders must demonstrate trust, respect, and openness.</i>	2	11	RICH DAD'S WHO TOOK MY MONEY? Robert T. Kiyosaki with Sharon L. Lechter, CPA (Warner Business • \$16.95) <i>How to score "ultrahigh" investment returns.</i>
12	THE TOTAL MONEY MAKEOVER Dave Ramsey (Thomas Nelson • \$24.95) <i>Getting rid of debt and building up your rainy-day reserves.</i>	9	12	THE 48 LAWS OF POWER Robert Greene (Penguin • \$17) <i>Rules for strivers, drawn from the likes of Machiavelli, Catherine the Great, and Henry Kissinger.</i>
13	PURPLE COW Seth Godin (Portfolio • \$19.95) <i>Emulate Krispy Kreme and Dutch Boy paints, and astonish your customers.</i>	14	13	THE FINISH RICH WORKBOOK David Bach (Broadway • \$14.95) <i>Track what you spend, etc.</i>
14	CONFRONTING REALITY Larry Bossidy, Ram Charan (Crown Business • \$27.50) <i>Zoning in on your business model.</i>	3	14	INVESTING FOR DUMMIES Eric Tyson, MBA (Wiley • \$21.99) <i>Stocks, bonds, real estate, small business—you name it.</i>
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BY STEPHEN H. WILDSTROM

And for Steve Jobs's Next Trick...

By far the world's most popular design for a personal computer is a box, the processing unit with a separate monitor and keyboard. Strangely enough, it has been seven long years since Apple Computer offered such a computer aimed at consumer and educational markets. But having finally done so, Apple has come up with a product worth the wait.

The new Mac Mini, starting at an impressively low \$499, brings Apple into the consumer mainstream. As you would expect for a product from Steven Jobs's Apple, it is utterly unlike anything else on the market (page 96). Most desktops, even high-end ones, are metal boxes with the style and grace of a gym locker. The Mini is a square box, 6½ inches on a side and 2 inches high, with brushed aluminum sides and a white plastic top. (There is a substantial external power brick that can be hidden away on the floor.) The front is marked only by a tiny power-on light and a slot for CDs or DVDs. The PowerPC G4 processor is a lot slower than the G5 in current Power Macs and iMacs, but it's speedy enough for most typical uses.

APPLE ALSO MAKES a virtue out of the fact that the new machine comes with no monitor, keyboard, or mouse. You can use the Mini with any of the hundreds of displays available from about \$100 and up. If you are replacing something other than an all-in-one eMac or iMac, you can use your old display. The lack of a keyboard and mouse strikes me mostly as a packaging gimmick that lets Apple sell the Mini in a box not much bigger than the one an iPod comes in. I used the new Mac with Microsoft and Logitech keyboards and mice with no problems; the alt key corresponds to the Mac's "option" key and the Windows key to Mac's "command." Mice, including wheel mice, work without additional software.

The Mini has few options and limited upgrade potential and, unlike other Macs, the Mini cannot be upgraded by the user. So consider the options before you buy. Choices include Wi-Fi wireless networking (\$79) and Bluetooth short-range wireless (\$50, or \$99 for both). The 256 megabytes of memory can go to 1 gigabyte; I recommend at least 512 megabytes, which will cost you \$75. A DVD recorder will set you back another \$100.

The real importance of the Mini is that it overcomes the twin barriers that have kept Apple out of many homes: cost and lack of design flexibility. Yes, you can buy a serviceable



Windows PC for even less—for example, a Dell Dimension 2400 with no monitor for \$319 after rebate—but you'll get a box that's big, ugly, and a lot noisier.

Lovely as the Mini is, software is a more compelling reason to buy it. Mac OS X offers the best combination of elegance and stability of any operating system. And Apple bundles some very good software, including the iPhoto picture-management program, iMovie video editing, and GarageBand music creation software.

Mac fans usually overrate OS X's security advantage over Windows. A big part of its edge is that it has not been challenged seriously by hackers, and Apple sends out—very quietly—about as many security patches as Microsoft. That said, the Mac does have inherent security advantages, and it is much less prone to the sort of mysterious

The Mac Mini offers flexibility and style at just \$499

glitches that often make Windows a challenge.

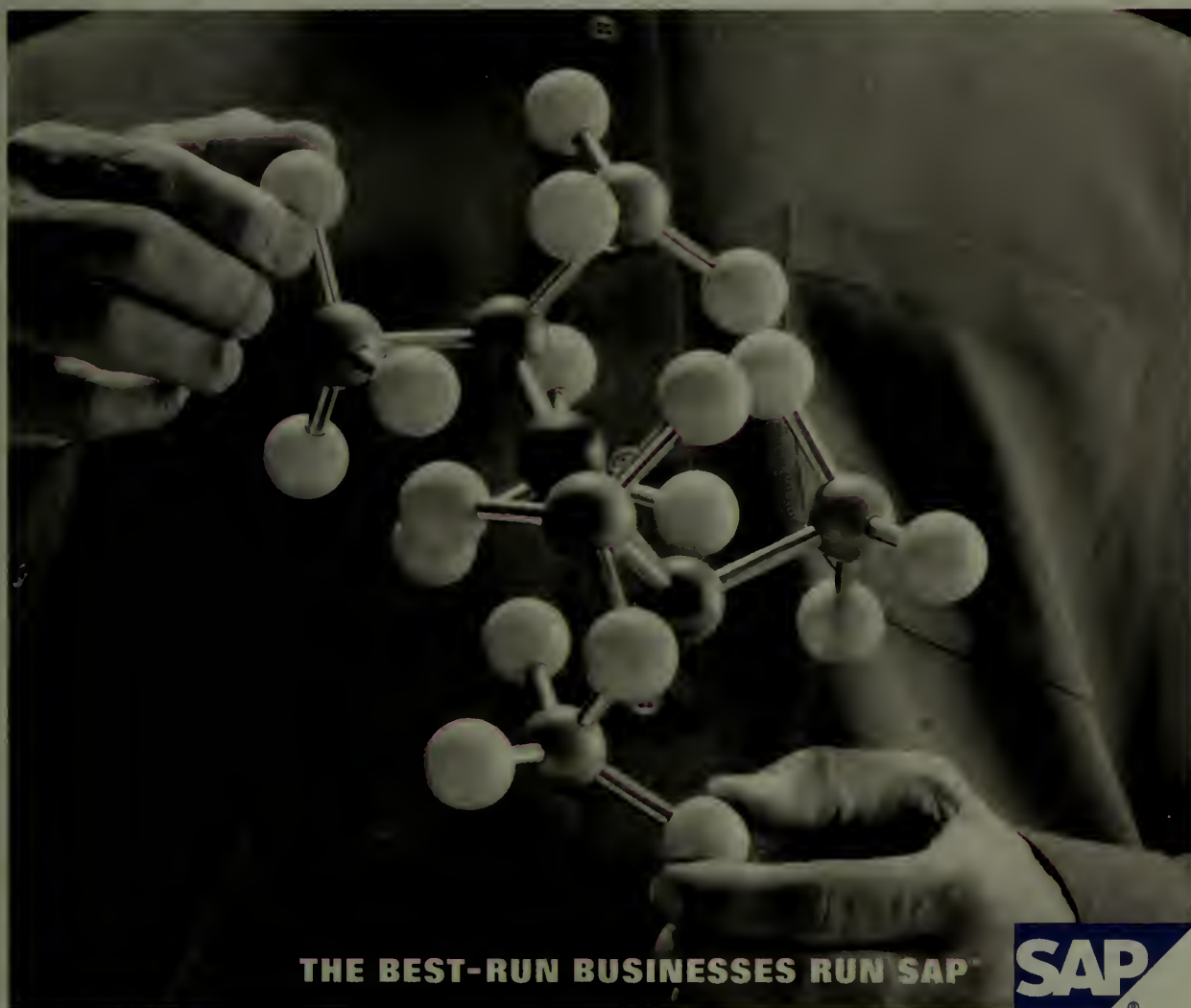
Unless you are dependent on a program that is available only for Windows, software compatibility isn't much of a concern. Apple's \$79 iWork package includes a new word processor called Pages, and Keynote, a PowerPoint competitor. But if file compatibility is at all an issue, I would recommend Microsoft's Office:mac. A student and teacher edition for home use costs just \$149.

I don't know if the Mini will increase Apple's market share, but it should. It is all the computer most homes, schools, and small businesses need in a tiny, elegant package. The only wonder is that it took so long. ■

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BY GLENN HUBBARD

Social Security: Pick the Best Part of Every Plan

The debate over Social Security reform is framed in a way that pits concerns about a “crisis” against claims that the current system merely needs some minor fixes. That’s a pity because the real question should be how to design a Social Security system that builds on the program’s success in lifting seniors out of poverty while helping all Americans prepare for retirement.

If we were starting from scratch, we would likely design a Social Security system that builds individual savings for retirement. Making such saving compulsory, as in the current system, would avoid the cost of supporting individuals otherwise unprepared for retirement. Incorporating a minimum benefit would allow the system to be progressive. But we aren’t starting from scratch. Social Security’s fiscal problems are real. So a better program should emphasize three pieces:

CREATE PERSONAL ACCOUNTS. A pre-funded Social Security system generates real savings to provide future retirement benefits. As with 401(k) pension plans, funds can be placed in personal accounts. Social Security personal accounts also reduce the political risk of diverting Social Security money to fund other government spending. Such accounts offer an opportunity to build wealth and a bequeathable asset. An account balanced between broad stock and bond index funds could increase resources for retirement with modest risk and costs.

Some Wall Street analysts worry that diverting payroll taxes to fund personal accounts will create large “transition costs” of Social Security reform because the continued payment of current benefits necessitates additional borrowing. Once Social Security’s long-term financial footing is restored, avoiding transition costs associated with personal accounts is straightforward. Future traditional benefits would be reduced so that the present value of the combination of personal account contributions and traditional benefits remains unaffected.

STRENGTHEN BENEFITS FOR LOW-INCOME WORKERS. Social Security’s central role is to be a safety net for seniors. And safety-net benefits to keep seniors out of poverty should be a vital part of a 21st century Social Security system. One way to accomplish that would be to guarantee a minimum benefit. A second alternative would be to set a more generous initial benefit for low-lifetime-income workers than for middle- and high-lifetime-income workers. Finally, contributions of low-income individuals to personal accounts could be matched in some proportion with public contributions to bolster future income in retirement.

RESTORE LONG-TERM FINANCIAL STABILITY. The present value of Social Security’s unfunded liabilities is in the trillions of dollars. And faster economic growth alone will not eliminate the shortfall. This is because when workers’ initial Social

Security benefits are set at the time of retirement, their average earnings over their careers are adjusted higher by average wage gains over their careers. This “wage indexing” locks productivity gains over a worker’s career, capturing the benefit of more rapid economic growth in higher benefits.

One way out of the fiscal trap is to slow the rate of growth of Social Security benefits. “Price indexing” would adjust new retirees’ career earnings by the rise in prices over their careers. Over a long horizon the shift eliminates Social Security’s financial shortfall and then some. These savings could be used to raise the benefits of low-income workers in retirement.

Of course we could choose to solve the Social Security funding problem with higher payroll taxes and/or higher income taxes. But such hikes would discourage work and entrepreneurship. These costs of tax increases hurt economic growth and our ability to fund Social Security, Medicare, and all of our public obligations.

The pieces can be combined in different ways. We can create personal accounts, strengthen benefits for low-income workers, and stabilize Social Security’s financial footing without requiring strict adherence to the details of

one proposal. Personal accounts could be added on to or carved out of traditional Social Security benefits depending on the details of the actuarial adjustment we make to Social Security benefits. Enhanced support for low-income workers could come through supplements to personal accounts or traditional benefits.

Restoring Social Security’s financial health is important. Equally vital is the chance to boost the system’s ability to meet the retirement needs of millions of Americans. Failing the first challenge would be perilous, but ignoring the second would be a bigger insult to what Social Security has already achieved.

Glenn Hubbard is dean of Columbia Business School. He chaired the Council of Economic Advisers from February, 2002 to March, 2003.

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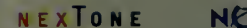
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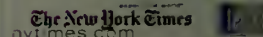
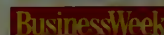
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JAMES C. COOPER & KATHLEEN MADIGAN

The Fed: Trying to Shift into Neutral

fortunately, no one knows the rate that neither helps nor hinders growth

U.S. ECONOMY To the surprise of no one, the Federal Reserve raised interest rates again on Feb. 2 after its two-day meeting to discuss monetary policy. And the Fed offered nothing to change the current broad expectation that it will continue its self-described "measured pace" of hiking rates by a quarter-point at each of the next

meetings scheduled for the first half of 2005.

After that, the Fed will have to confront two major questions about its goals for monetary policy: What rate constitutes a neutral rate, which neither helps nor hinders growth? And when might the Fed have to move policy into the restrictive zone, raising rates so that economic activity begins to feel the pinch, in an effort to nip building inflation pressures?

Be sure, this is not the typical course of rate-hiking. Usually by the fourth year of expansion, the Fed is raising rates in an effort to choke off budding price pressures coming from superhot demand, overextended factories, tight job markets. But the latest data on real gross domestic product, labor costs, and factory activity show signs of an overheating economy or rising wages.

Moreover, the financial markets have not reacted badly to the rate hikes. That's partly because policymakers have clarified their intentions with extraordinary clarity. As a result, investors and traders have been fully prepared for each of the six bump-ups in rates since June, 2004. The central bank's Feb. 2 policy statement contained the same language used after the last meeting on Dec. 14. With little change in Fed thinking, the financial markets' reaction was muted.

If all goes as expected, by June 30 the Fed will have raised the federal funds rate to 3.25%, and the bulk of the work in getting to neutral will be done. At that point, the Fed may feel comfortable enough to take a break from hiking to assess the success of their efforts.

PROBLEM for the Fed: No one knows for sure what rate constitutes a neutral funds rate. Economists generally set a target of 3.5% to 4%, but those estimates are usually based on historical averages. In today's economy, the neutral rate may even be higher than in the past. In a high-productivity economy generally offers higher rates of return, interest rates across the board can rise without exerting a drag on the economy. Plus, the current slower rate of job growth means the economy can grow much faster without generating price pressures. In fact, the Fed will know it has reached neutrality not by setting a specific rate, but by observing economic and inflation trends. To that end, the bank's primary focus, as

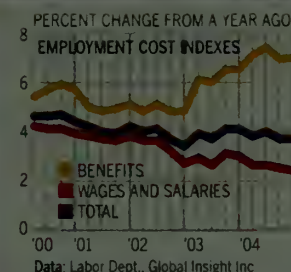
always, will be the job markets. Inflation pressures come mostly from the cost side, and businesses' biggest costs come from labor. The latest report on employment costs was Fed-friendly. Total compensation rose a less-than-expected 0.7% in the fourth quarter over the third. For all of 2004, total wages, salaries, and benefits rose 3.7%.

Wages and salaries alone grew just 2.4% last year, the

smallest annual advance in the 24 years that the Labor Dept. has compiled records. Some of the slowdown probably reflects companies' efforts to offset higher benefit costs (chart). Benefits jumped 6.9% in 2004, the biggest yearly gain since 1983.

Benefits were rising even faster in mid-2004, but a deceleration in

COOLER WAGE GROWTH OFFSETS BENEFIT COSTS



health-care costs slowed growth for all bennies. Labor cautioned, however, that the data may be understating health costs because they do not capture cases where employees have to pay a larger share of medical expenses.

EVEN SO, the overall slowdown in compensation means that labor costs are not ramping up as quickly as might have been expected given the turnaround in job growth in 2004. Labor markets haven't tightened enough to worry the Fed about near-term cost pressures. The unemployment rate will have to get well below 5% before tight labor markets become an issue.

That's true even though productivity is set to slow this year. As the employment cost report shows, businesses are keeping an eagle eye on labor expenses. So while unit labor costs will be rising in 2005, the pace probably won't be strong enough to shift inflation into a higher gear. Plus, stiff domestic and foreign competition will force companies to absorb higher costs in their profit margins, rather than risk losing market share by raising prices.

Likewise, the industrial sector began 2005 on solid ground. But the increased activity is unlikely to alarm

policymakers because factories aren't facing bottlenecks. Plus, the influx of imports into the U.S. means that slack capacity is now measured globally, not locally.

The Institute for Supply Management reported that industrial activity increased in January, but at a slower pace than in December. Production sped up last month, but orders growth weakened.

But more important for the Fed, the ISM's indexes on vendor deliveries, prices, and inventories all supported the notion that price pressures may actually be easing. The index for delivery times has fallen in each month since May, meaning businesses are not waiting as long for deliveries as they used to. And the percentage of purchasers reporting price increases is falling (chart).

Also, inventories are looking better. The percentage of purchasers who said their customers' inventories were too low fell for the second month in a row. On top of the ISM news is the Fed's own tracking of industrial operating rates. Manufacturing in December used only 77.8% of its available capacity. Past patterns suggest the Fed is not going to worry about capacity constraints until demand causes operating rates to exceed 83%, delivery times to lengthen sharply, and inventories to shrink again.

INDEED, ONE BIG PLUS for policy is that demand is solid enough that it doesn't need the help from low interest rates. But it is not so hot as to risk overheating, which would force the Fed to move more aggressively.

Real gross domestic product grew at a 3.1% annual rate in the fourth quarter. The gain was less than

expected partly because the trade deficit was bigger economists had estimated. However, a few days after GDP release, Statistics Canada found an error in its data, meaning the fall in U.S. exports contained in the GDP report was overstated. Estimates suggest that the error left GDP growth about 0.3% to 0.4% lower than

should have been. The Commerce Dept. will correct for that when it reports its revisions of GDP data on Feb. 25.

Domestic demand grew by a solid 4.3% pace last quarter, with business investment in equipment and software jumping 14.9%. That's good news for the Fed because companies are still focused on



increasing their productivity by investing in high-tech machinery.

This latest GDP report, along with the news on labor costs and delivery times, suggests 2005 will be a Fed-friendly year. But make no mistake, policymakers will be complacent. One hallmark of the Greenspan Fed is willingness to move preemptively. If the outlook changes suddenly and the economic data raise worries about inflation, you can be sure policymakers will shift their goals to meet the new challenge. ■

BRITAIN

Enough Growth to Buoy Blair?

PRIME MINISTER Tony Blair has said he will put the economy at the center of his bid for a third term. A few days ago, the plan seemed questionable. Now the strategy is looking sounder.

Blair's forecast for economic growth of between 3% and 3.5% for 2005 is above many private forecasters' expectations. Moreover, industrial production is falling, and retailers suffered their worst Christmas season in decades. The fear: Consumer spending could crumble under the weight of higher interest rates and a burst housing bubble, dragging down the economy.

The latest reports, however, allay some of those worries. In

particular, real gross domestic product in the fourth quarter grew a greater-than-expected 0.7% from the third quarter. That's equal to a 3% annual rate and faster than the third quarter's 0.5% gain. Growth for the year was a healthy 3.1%, up from 2.2% in 2003.

The economy's strength remains concentrated in the services sector, which accounts for 72% of GDP.

Service output, buoyed by strong growth in business services and finance, rose 1% last quarter, outpacing the third quarter's 0.9% rise.

To be sure, the manufacturing and retail sectors were weak. Manufacturing output fell 0.2%, the second quarterly decline in a row. But

that weakness mainly reflected downtime for maintenance in oil gas extraction, which was complete by October. And the British Chamber of Commerce reported very strong export orders for the fourth quarter.

Output in the retailing sector posted a slim 0.3% gain, the weakest in nearly two years. Nevertheless, through January, house prices appear to be stabilizing, not collapsing, and January consumer confidence hit a two-year high. These trends imply a more resilient consumer sector than the bleak December retail sales numbers suggested. And amid tight labor markets, wages are growing in the 4%-to-4.5% range, well above December's 1.6% inflation rate.

With Blair likely to call for elections as early as May, the Treasury is already talking up the latest data. And while the economy's strength is not broadly based, it may well prove politically sufficient. ■

CONSUMERS' SPIRITS ARE ON THE RISE





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STRATEGIES

BRANDING: FIVE NEW LESSONS

The P&G purchase of Gillette shows that innovation is key, and marketing is more diffuse and personal

THE LAST TIME DETERGENT and toothpaste giant Procter & Gamble Co. made a bid for razor-maker Gillette Co., it was out of desperation. Back in 2000, when the Cincinnati giant made an unsolicited bid, Gillette was a bargain: Despite its hit Mach3 razor, a series of earnings disappointments had hammered the stock.

P&G was struggling, too, and so were a lot of other once-invincible brands. With fracturing TV audiences moving to the Web and cable, the classic 30-second spot that had made household names of the likes of Mr. Clean and Tide was losing traction. Consumers were starting to identify more with niche markets than with the one-size-fits-all brands that had long been the backbone of the consumer-products industry. Retail shelves were stocked with private-label rivals. Most frightening of all: The information-packed Internet threatened to expose those brands as nothing special. The age of the giant, mass-market brand seemed to be dead—and so was a P&G-Gillette deal.

Oh, what a different story it was on Jan. 28 when it was announced that the wedding was on. Sales growth at both companies is on a tear, earnings and margins are up, and hit products are rolling out of their labs. P&G's sales growth is running

at 8% a year, excluding acquisitions—double the rate of the 1990s. And the once-struggling razormaker fetched a price of \$57 billion, 19 times earnings before interest, taxes, and depreciation. Why did Gillette do the deal? “I have a simple formula,” says CEO James Kilts. “Strength plus strength equals success.”

Are brands back? Well, yes and no. It's not that the doom sayers were all wrong. Media are becoming infinitely more complex. Big retailers—especially Wal-Mart Stores Inc.—are more powerful than ever, pressuring the profits that big brands need to fuel marketing and innovation. And every year shows consumers becoming more cynical about advertising. It's no wonder so many brands have faltered: Coca-Cola, Levi Strauss & Co., Kodak, Ford—the list goes on.

But the savviest brand managers have adapted, creating a new paradigm in which innovation is king, marketing is diffuse and personal, and size can be an advantage. Nothing shows this more than perennial No. 1 detergent Tide, where P&G's stepped-up consumer research, brand extensions, and ads have reawakened it within a moribund category.

Here are five lessons from classic

TURNING TIDE P&G used consumer research and tactics from other brands to give its detergent fresh traction

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32 | The trade deficit: What's up with exports?

36 | SBC's AT&T deal is a minefield of challenge



companies and upstarts alike. All are thriving by managing brands differently than companies did in the heyday of the mass market.

1 Innovate. Innovate. Innovate.

Why would P&G tinker with Tide? Long the detergent leader, Tide would seem best left alone, a profitable annuity on years of mass-market flogging in the '60s, '70s, and '80s. But P&G has tinkered nonetheless, combining strong technology and consumer research to push sales up 2.6% over the last year in a category that is growing less than 1%. The secret: a widening family of detergents and cleaners that now includes everything from Tide Coldwater, for cold-water washing, to Tide Kick, a combination measuring cup and stain penetrator.

Innovation isn't always built from scratch. P&G is a master at transferring technologies from one brand to another. Tide StainBrush, a new electric brush for removing stains, uses the same basic mechanism as the Crest Spinbrush Pro toothbrush—also a P&G brand. Gillette, too, is adept at cross-pollination. Its latest winner is the battery-operated M3Power, the result of a collaboration between the company's razor, Duracell battery, and Braun small-appliance units. Despite a 50% price premium over what Gillette charged for its previous top-of-the-line razor, the M3Power has captured a 35% share of the U.S. razor market in seven months.



GILLETTE Savvy collaboration among units boosted sales

2 Move Fast—Or Lose Out

Not only are customers hooked on innovation, they're demanding it faster. Handbag designer Coach Inc. once introduced new products quarterly; now they come out monthly. On Coach's Web site, the new line currently features a bevy of options, from a \$498 suede tote bag covered in an oversized pink and purple logo pattern to the "Coach Soho Nappa Small Tortilla," a white leather number with a tasseled and a \$328 price tag. "For brands to stay relevant, they have to stay on their toes. Complacency has no place in this market," says CEO Lew Frankfort. In any given month, Frankfort says, new products account for 30% of U.S. retail store sales.

3 Minimize Exposure to Wal-Mart

Wal-Mart is the key customer for any consumer product brand today. But balancing those sales with plenty of others is vital to a brand's health: For most suppliers, the more you sell to the world's biggest retailer, the less you make. In a recent study by consultant Bain & Co. of 38 companies doing 10% or more of their volume through Wal-Mart, only 24% sustained above-average profitability and shareholder returns. P&G, which sells 18% of its goods through Wal-Mart, was one. It has done so by shifting business away from basic products such as paper towels, which can easily be knocked off by a private label, to higher-margin products such as health and beauty care, including its line of Olay skin products.

It's not as if Wal-Mart is the only game in town—though sometimes it might seem that way. Besides low prices, Americans crave convenience. Increasingly, consumers are shunning supermarkets and buying food at convenience stores, fast-food outlets, club stores, and elsewhere. Recognizing that, Kellogg Co. began thinking outside the supermarket aisle in 2001 when

it bought Keebler Co. and its links to vending machine Nutri-Grain bars, Pop-Tarts, and even single-serving bowls are available at many more places, and the Battle Creek (Mich.) company has gone from providing breakfast cereals to round-the-clock snacks.

4 The New Media Message

The splintering media, it turns out, hasn't been a problem for P&G. P&G is a longtime master of what a former executive called "surround-sound marketing"—everything from in-store demos to pitches on Wal-Mart TV, engulfing shoppers with a brand message. But it has also become a pioneer of new techniques, such as integrating its Crest Whitening Expressions Refreshing Vanilla Mint into a recent episode of the TV show *The Apprentice*. The goal is to both target specific customers and to fit the medium to the message. Recent research showed that girls wanted to know more about Tampax, P&G shifted a child's advertising from TV to print and created a Web site called Beinggirl.com. "It's hard to convey a lot of information and stuff that's kept very personal in a 30-second TV ad," says David Woehrle, vice-president for North America marketing. "Print and online were terrific."

5 Think Broadly

Rather than define itself by its products, P&G has expanded its market to become a solver of every problem in the home. While toothpaste rival Colgate and Palmolive Co. was focusing on the tube, P&G grabbed greater "share of the mouth" with innovations such as the inexpensive Crest toothbrush and premium-priced White Glister teeth-whitening kits.

Apple Computer Inc., which was late to market with its portable music player, the iPod, took the lead nevertheless with a combination of great product design and marketing buzz. But why were consumers willing to accept a computer made by a consumer-electronics company? Because Apple made a brand stand not for desktop computing but for imagination and fun. "The iPod is about creative people doing creative things," says David Placek, president of Lexicon Branding in Sausalito, Calif.

Such thinking can fuel a rise to megabrand status in a fraction of the time it once took. The proof: Starbucks Corp., the Seattle-based coffee chain does plenty of core innovation. Part of its holiday profit surge of 31.2% belongs to its new pumpkin spice latte. But that's just the start. Anne Sauro, senior vice-president for marketing, sees the cafés not just as a place to slurp java but as somewhere "to connect with people or as a getaway." That broader vision has led to offerings such as music and wireless Web connections.

Today, 30 million people visit a Starbucks each week. The average customer stops in 18 times a month. With no tagline and sparse traditional advertising, Starbucks has gone from an obscure brand to being one of the most popular and valuable brands on the planet in under 20 years. "Starbucks, based on the old model, shouldn't be able to happen," says Kelly O'Keefe, CEO at the strategy firm Emergence. But it has—and it's a whole new world.

—By Nanette Byrnes in New York and Robert Berner in Chicago, with Wendy Zellner in Dallas, William C. Symington in Boston, and bureau reporters

INVESTING

Learning to Think Like Warren Buffett

One way Warren E. Buffett became the world's most successful investor was by understanding how putting off tax payments can build wealth. Every year in the "owner's manual" included with Berkshire Hathaway Inc. annual reports, he spells out the advantages of deferred tax liabilities over ordinary debt. His essays show how Berkshire boosts returns by keeping cash invested as long as practical until sending it to the U.S. Treasury. Now, with his Jan. 28 backing of Procter & Gamble Co.'s novel two-step, tax-free deal with Gillette Co., Buffett is again seizing an opportunity to exit a position without triggering a giant tax bill. Berkshire's gain on the 96 million Gillette shares it has held since 1989: \$4.3 billion. Yet because it is moving all of that gain into shares of the company, Uncle Sam will have to wait for his piece of the profits.

Exactly who suggested the deal structure is not clear. Whether Buffett, Gillette's largest shareholder, nor the investment bankers involved would comment. Given Buffett's well-known aversion to taxes, though, bankers most likely devised the structure to satisfy him while preventing an all-stock deal from drastically watering down P&G's earnings. Just as

important, the ingenious structure could become a Wall Street model for future mergers and acquisitions. At the same time it comes with a lesson about what investors can and can't learn from watching Buffett.

Think of the deal as a two-step jig: The first movement makes Buffett happy, while the unusual second step pleases P&G. First, P&G will pay for Gillette with nothing but stock, issuing 0.975 shares of its common stock for each Gillette share. Gillette investors will owe no tax since they're exchanging one stock for another. If, instead, P&G had paid for Gillette with cash, Berkshire alone would have faced a whopping \$1.5 billion tax bill thanks to the 35% corporate rate it pays.

Problem is, all that new stock will dilute the value of the shares P&G's current investors hold and slash its earnings per share. So as part of the deal P&G announced that it will spend \$18 billion to

\$22 billion over the next 12 to 18 months buying back some of the stock it just issued for Gillette. The result, says P&G, is the same as if it had paid for Gillette with a package of 60% stock and 40% cash.

Why not just structure a 60-40 deal in the first place? Because that could leave many Gillette shareholders with an unwanted tax bill, as happened to Buffett in 1996. Then, Capital Cities/ABC Inc., in which Buffett held a \$2.2 billion unrealized profit, sold out to Walt Disney Co. Disney agreed to pay partially in stock, but when the Disney shares were divided among all Cap Cities shareholders who wanted them, Buffett ended up with half his money in cash—and a tax bill of some \$400 million.

P&G's two-step gets around that. Gillette shareholders can keep as much stock as they want, controlling when their taxes come due. Tax-exempt pension funds or others who want to cash out can sell in the open market whenever they choose. And because P&G will be spending billions on the buyback, there's less risk that a wave of investors selling out will send the shares tumbling. "It is very democratic," says Lawrence A. Cunningham, professor of law and business at Boston College and the editor of a book of Buffett's essays.

Of course, tax concerns are not all that drives Buffett's decisions. He has proven that by selling winning positions for cash, such as stakes in Disney and Freddie Mac. Still, given the huge capital gains—and deferred taxes—Berkshire has racked up on key holdings such as American Express and Coca-Cola, they are clearly important. And taxes should be a bigger concern to Buffett than to many others: Berkshire's 35% corporate rate is more than twice the 15% individuals pay on capital gains.

Therein lies a lesson for investors trying to piggyback on Buffett's picks. Many assume that if he owns a stock, it's worth buying. But because Berkshire's tax rate is so high, Buffett bears less risk holding overpriced stocks. After tax, he would give up only 65% of profits foregone by not selling at a high, while an individual would forfeit 85%. By the same token, on those occasions when he does sell and offer Uncle Sam his 35% cut, he's sending a loud signal that the outlook is bleak. But since Buffett never reveals what he's selling until he's done, it's hard to play copycat. Investors are better off trying to learn how Buffett thinks.

—By David Henry in New York

SCORE The structure of the P&G-Gillette deal will save Berkshire \$1.5 billion

Put Off the Tax Bite

Rather than cash out and pay a big tax bill, Buffett likes to keep his Berkshire Hathaway holdings invested

	UNREALIZED GAINS (BILLIONS)	DEFERRED TAXES (BILLIONS)
AMERICAN EXPRESS	\$7.0	\$2.4
COCA-COLA	7.1	2.5
GILLETTE	4.3	1.5
WELLS FARGO	3.0	1.0

Based on Feb. 2 stock prices, holdings as of September, 2004, with a 35% corporate tax rate. Data: Company reports and BusinessWeek

COMMENTARY

BY HOWARD GLECKMAN

The Fog of the Budget

How Bush will mask the biggest national debt in history

IN HIS FEB. 2 STATE OF THE UNION address, George W. Bush laid out the overarching goals of his second term—building a stable, friendly state in Iraq and remaking the Social Security system with individual investment accounts. The President's ambition may know no bounds, but at the opening of his remarks, he acknowledged that a federal budget that has been gushing rivers of red ink will have to be dealt with in a second term. "America's prosperity requires restraining the spending appetite of the federal government," he said. "The principle here is clear: A taxpayer dollar must be spent wisely, or not at all."

Stirring words, to be sure, but as the time comes for Bush to put numbers behind his aggressive agenda, the usually bold President is likely to become uncharacteristically reticent. In the \$2.5 trillion budget he plans to present to Congress on Feb. 7, the President will say hardly a word about the cost of his most important domestic and foreign initiatives. Instead, he'll trumpet spending cuts that may grab headlines but will have little impact on the tide of red ink that Bush has ridden since 2001.

White House budget writers of both parties have a long history of fiscal gimmickry. In 1981, President Ronald Reagan relied on a "rosy scenario"—optimistic economic assumptions—to show he could shrink deficits while cutting taxes. President Clinton never liked to propose cutting programs right away. Instead, he'd promise to trim such spending in future years but leave the actual cuts to Congress—the better to shift the blame. And as Social Security moved from balance to deficits to cash cow, Presidents have moved it on and off the budget to suit their needs. But those tricks hid mere billions of dollars. Bush's new spending plan will mask trillions.

'Beyond Chutzpah'

THIS BUDGET—which will cover fiscal years 2006 through 2010—will largely ignore the costs of Bush's own top priorities, including Iraq, restructuring Social Security, and taming the Alternative Minimum Tax. Nor will it reflect the long-term costs of

making his 2001 and 2002 tax cuts permanent, which largely occur starting in 2011. At the same time, it will spotlight initiatives that are unlikely to save much money, such as aggressively freezing spending on most domestic programs or slowing the growth in federal funding for Medicaid, the joint federal-state health program for the poor.

Such legerdemain will allow Bush to claim that he will hit his goal of slicing the deficit in half by fiscal 2009, the last year he'll propose. But in reality, it will obscure an agenda likely to generate ever-larger deficits over the coming decade. "It will show how tough the President can be on [some] spending," says Robert L. Bixby, executive director of the Congressional Coalition, a nonpartisan group that advocates balanced budgets. "But to leave out Social Security, the AMT, and the war in Iraq and say you have a plan to cut the deficit in half over five years is beyond chutzpah."

Administration officials insist the omissions are justified. While Bush described his ideas for Social Security in his State of the Union speech, the White House doesn't have a specific plan to cost it out. And, Bush insists, the price of the Iraq war can't be estimated in advance. "The President is making clear he will put all his resources behind [his] vision," says a White House official. "But it's not appropriate to stick numbers plucked out of thin air."

But Social Security aside, there's little disagreement on the price of other key items on Bush's agenda. If the costs of Iraq, AMT relief, and making tax cuts permanent were included, the projected deficit in 2009 would be closer to \$400 billion than the \$250 billion Bush is likely to cite. Over the next 10 years, those three items could add almost \$3 trillion more to the national debt than Bush's budget will claim, according to the nonpartisan Congressional Budget Office. Even if Bush froze most domestic spending over the decade, he'd still add an extra \$2 trillion in debt.

As a result, Bush's budget resembles Swiss cheese—and the holes may be more interesting than the substance. Start with Iraq. On Jan. 24, Lt. Gen. James J. Lovelace Jr., the director of Army operations, said that for budget planning purposes the Pentagon was assuming the U.S. would maintain current troop levels in that war-torn country at least through calendar 2010. The CBO figures the price tag at \$70 billion a year. But the administration's budget will not include any new money to keep U.S. troops on the ground after Sept. 30, 2005.

The Administration acknowledges it will ask for \$80 billion



RETICENT No price on Social Security reform



The President's Budget

WHAT HE'LL LEAVE OUT

WAR IN IRAQ Funding requests for costs expected to run \$70 billion a year through 2006 will come later

SOCIAL SECURITY Estimates of the potential tab for reform—up to \$2 trillion over 10 years

ALTERNATIVE MINIMUM TAX The \$500 billion price tag to protect more than 25 million middle-class families who could get hit by the AMT by 2010

WHAT HE'S LIKELY TO INCLUDE

ENTITLEMENT LIMITS Sharp restrictions in the growth of Medicaid, a program funded jointly by Washington and the states

SPENDING FREEZE No new spending on most domestic programs, such as housing and the environment

TARGETED INCREASES Modest new funding for education initiatives and Internal Revenue Service enforcement

IRAQ PATROL

troops are to be in Iraq through 2006

but not until after the budget comes out. "Iraq is not in the budget because [including] it accentuates the cost of the war," says University of Maryland political scientist Allen Schick.

Such the same will happen with restructuring Social Security. Bush's top domestic priority. Estimates of the cost of shifting to a new system range from \$1 trillion to \$2 trillion over the next 10 years. But the Bush budget will include neither details nor any estimate of its cost.

Then there is the AMT—a parallel tax system that today imposes a second, higher tab on about 3 million mostly middle-class families. The levy's exemptions are not indexed for inflation, so as incomes grow, as many as 30 million families could be hitting the AMT by 2010. Bush vowed in his reelection campaign to fix the mess, but that would cost more than \$500 billion over the next 10 years. His budget will include some recognition of the need for a fix. But it is likely to request only a modest sum for a temporary one-year patch. Longer-term reform, the White House says, must await proposals for broader budget changes that are not due until summer.

Similarly, the budget will exclude the costs of making permanent Bush's tax cuts, such as lower rates and the repeal of the estate tax. Because the budget will only project deficits through 2010, it will not include the costs of extending the tax cuts, which start to bite in 2011. The price tag: nearly \$1.5 trillion from 2011 to 2015.

Domestic Spending Freeze

THE BUSH'S BUDGET ignores these big-ticket items, it will not reflect savings from holding down growth in government spending. Trouble is, while those changes could have a major impact on the programs themselves—and on those who benefit from them—they won't have much impact on the overall deficit. The President's major target will be what's known in Wash-

ington-speak as domestic discretionary spending. He'll propose boosting spending for the Pentagon and homeland security in 2006. But spending on the rest of government, from parks to cancer research, will be all but frozen at this year's levels.

Bush will promote that freeze as tough fiscal restraint. And a GOP-controlled Congress is likely to give him what he wants. But, in reality, such cuts would trim less than \$10 billion a year from the \$2.5 trillion budget.

To make his numbers work, Bush will also propose major cuts in future spending for Medicaid. Some observers expect the White House will ask Congress to slash the \$200 billion program by \$10 billion a year.

The chairmen of both the House and Senate Budget Committees are likely to back such Medicaid cuts. But while the program may be in for some modest trimming, Democratic and Republican governors alike are lining up to oppose any big changes. Major cuts in federal contributions would shift more of the burden of Medicaid to the states, which already pay for about half of its costs.

Bush's efforts to trim any government spending will run head-on into a deeply split congressional GOP. Many hard-core House conservatives, such as Majority Leader Tom DeLay of Texas, strongly favor big cuts in domestic programs—not to trim deficits, but because they want to eliminate what they see as big government. But House moderates and many Senate Republicans, such as Lincoln Chafee of Rhode Island, will oppose cuts in popular social programs. And in the Senate, a faction including Budget Committee Chairman Judd Gregg (R-N.H.) is focused much more on the long-term costs of Social Security and Medicare.

When the congressional fiscal wars finally conclude next fall, Bush will likely get his freeze on domestic spending. But the rest of his budget may be largely forgotten. What will be hard to overlook, though, is this: Washington could well be looking at deficits in the range of \$400 billion-plus for the rest of his Presidency. ■



BRIGHT SPOT The global boom in mining has boosted Caterpillar's sales abroad

THE ECONOMY

The Export Engine Needs a Turbocharge

A decade ago, many economists were optimistic that U.S. companies would be able to boost exports strongly enough to keep up with Americans' rapidly rising appetite for imports. Most predicted that the U.S. trade deficit would stabilize at perhaps a fraction of 1% of gross domestic product. But while imports have boomed, exports have grown far more slowly than anyone expected, contributing to the biggest trade gap in history. The Commerce Dept. said on Jan. 28 that the trade deficit in goods and services hit an annual rate of \$688 billion in the fourth quarter of 2004, a record 5.7% of GDP.

Understanding why exports have fallen short is vital to explaining the size of the trade deficit—and the prospects for shrinking it. "This is one of those controversial [economic] issues," says Farid Abolfathi, a managing director at Global Insight Inc., a Lexington (Mass.) economic consulting firm. The problem isn't just the decline of U.S. manufacturing over the past decade. Indeed, the worst-performing export sector in recent years has not been goods. The less understood segment of "services"—which range from airline trips to international phone calls to movie royalties, U.S. tourism, education of foreign students, and legal advice—has lagged more.

The bottom line? While economists continue to puzzle out why exports haven't

grown faster, few expect a rapid turnaround. It could be five years or more before export growth makes a big dent in the trade deficit. That's because the U.S. is at the bottom of a deep hole. True, exports grew 17% over the past four quarters, vs. just 8% growth for imports. But because the \$1.9 trillion total that the U.S. imports is so much larger than the \$1.2 trillion it sells abroad, exports need to grow 58% faster than imports just to keep the trade gap from increasing.

Faster growth in exports of services will be vital. From 1996 to 2004, service exports rose just 27% after inflation, vs. 34% growth in goods exports. Travel and passenger fares purchased by foreigners fell in real terms, reflecting sluggish performance by U.S. tourism and airlines in the face of wars, visa restrictions, and for much of the period, a strong dollar. Royalties and license fees from other countries grew 38%—a number that was suppressed by intellectual-property theft. Hollywood alone estimates that it loses about \$3 billion a year from movie piracy.

The fastest-growing service export category has been "other private services," a

grab bag that includes education, legal, accounting, finance, insurance, and telecom. It has grown 79% after inflation since 1996. But even there, growth is less than it could be. Many U.S. companies, from PricewaterhouseCoopers to insurer American International Group Inc., are choosing to serve foreign markets from local offices rather than from the U.S.

It's also likely some service exports are being missed. When a U.S. company opens a plant abroad, as many have, it provides management as well as intellectual property such as patents and trademarks, from the home office. Those should be recorded as exports of services, but they may not always be, says Ralph H. Kozlow, associate director for international economics in the Commerce Dept.'s Bureau of Economic Analysis. He says the bureau is looking into undercounting of service exports and imports.

Don't look for miracles from goods exporters, either. Sure, some sectors are doing fine. The boom in mining around the world has boosted Caterpillar Inc.'s export of its gargantuan trucks and earth movers. But others are slipping. Agriculture, long one of the strongest export sectors, has recently flirted with trade deficits because of rising foreign competition, such as from Brazilian soybean farmers. Even the chemical industry, where exports have risen briskly since the mid-1990s, is flagging. 3M Co., which exported \$3 billion more than it imported last year, says it's making more investments abroad than at home.

Policymakers' two favorite ways to raise exports and shrink the deficit are faster foreign growth and a cheaper dollar, but neither is a quick fix. Even if both Japan and the European Union boosted their annual

growth rate by 2 percentage points and their imports from the U.S. went up the same amount, overall U.S. exports would rise a trivial \$6 billion a year. And the dollar is still off by only 15% from its peak three years ago, according to the Federal Reserve's trade-weighted, inflation-adjusted

index. That won't markedly boost sales of U.S. goods and services.

Increasing exports is key to shrinking the trade deficit. The question now is, what's the key to increasing exports?

—By Peter Coy in New York, Adrienne Carter and Michael Aronson in Chicago, and bureau reporters

NOT BUYING AMERICAN





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Confidence and pricey oil boosted earnings

WITH EARNINGS SEASON well under way again, all indications are that Corporate America turned in another robust performance as 2004 drew to a close. Analysts surveyed by Thomson First Call estimate that companies in the Standard & Poor's



500-stock index will post a 19.2% net income from continuing operations, excluding extraordinary and items, for the fourth quarter. Strong demand also continued to fuel growth: At the 321 companies in the S&P 500 that had reported by the morning of Feb. 2, revenues were up 13.8%.

What explains the robust picture? A gusher of earnings in the oil patch charged profits overall, as did Corporate America's endless penchant for cost-cutting. But CEOs' renewed confidence in the economy's strength also played a big role. With big wads of cash on their balance sheets, many CEOs are putting that money to work—reinvesting in infrastructure, rebuilding inventories. "People have finally willing to place bets," says John Swonk, chief economist of Chase Mesirow Financial. "That means investing in your company's future."

The Fourth Quarter: All's Well That Ends Well

	CURRENT QTR. SALES (MILLIONS)	% CHG.	QTR. PROFITS (MILLIONS)	% CHG.	THOMSON FIRST CALL DATA ANALYSTS' REPORTED				CURRENT QTR. (MILLIONS)
					EST. EPS	REPORTED EPS	DIFF.		
INDUSTRIALS	493,082.3	+15	34,778.3	+16	0.69	0.74	+0.05	FedEx ††	7,334.0
Altria Group	16,364.0	+7	1,990.0	-4	1.06	1.08	+0.02	Gannett	1,962.0
Archer Daniels Midland ††	9,063.5	-1	313.5	+42	0.39	0.41	+0.02	Goldman Sachs Group	7,455.0
Boeing	13,314.0	+1	182.0	-84	0.05	0.23	+0.18	HCA	5,940.0
Bristol-Myers Squibb	5,157.0	+2	139.0	-73	0.33	0.39	+0.06	JPMorgan Chase	17,483.0
Caterpillar	8,571.0	+33	551.0	+58	1.63	1.55	-0.08	McDonald's	5,010.0
ChevronTexaco	39,462.0	+40	3,440.0	+99	1.40	1.56	+0.16	McGraw-Hill	1,361.0
Colgate-Palmolive	2,803.3	+9	285.7	-23	0.59	0.59	—	Merrill Lynch	9,617.0
ConocoPhillips	35,101.0	+58	2,480.0	+152	3.07	3.51	+0.44	Morgan Stanley	10,420.0
Dow Chemical	10,936.0	+31	1,026.0	+10	0.71	0.85	+0.14	Sears, Roebuck	11,229.0
DuPont	6,000.0	-7	278.0	-56	0.33	0.37	+0.04	Southwest Airlines	1,655.0
Exxon Mobil	76,069.0	+27	8,420.0	+27	1.07	1.30	+0.23	U.S. Bancorp	3,824.0
Ford Motor	44,722.0	-3	64.0	NM	0.27	0.28	+0.01	UAL	3,988.0
General Electric	43,293.0	+18	5,378.0	+18	0.50	0.51	+0.01	Union Pacific	3,217.0
General Motors	51,344.0	+5	630.0	NM	0.91	1.01	+0.10	United Parcel Service	9,840.0
Georgia-Pacific	4,505.0	-14	15.0	-89	0.49	0.51	+0.02	UnitedHealth Group	10,511.0
Halliburton	5,201.0	-5	183.0	+25	0.48	0.44	-0.04	Wachovia	7,773.0
Johnson & Johnson	12,752.0	+13	1,217.0	-34	0.64	0.67	+0.03	Wells Fargo	9,347.0
Kraft Foods	8,784.0	+7	677.0	-21	0.49	0.49	—	TECHNOLOGY	75,790.0
Lilly (Eli)	3,644.3	+5	-2.4	NM	0.74	0.75	+0.01	Apple Computer †	3,490.0
Lockheed Martin	9,965.0	+11	372.0	+8	0.75	0.83	+0.08	Google	1,031.0
Merck	5,748.0	+2	1,101.1	-21	0.50	0.50	—	IBM	27,671.0
Nike ††	3,148.3	+11	261.9	+46	0.87	0.97	+0.10	Intel	9,598.0
Nucor	3,089.0	+86	341.4	NM	1.99	2.12	+0.13	Lucent Technologies †	2,335.0
Pfizer	14,924.0	+7	2,871.0	+369	0.59	0.58	-0.01	Microsoft ††	10,818.0
Procter & Gamble ††	14,452.0	+9	2,039.0	+12	0.72	0.74	+0.02	Motorola	8,842.0
Schering-Plough	2,184.0	+12	-834.0	NM	-0.01	-0.02	-0.01	Oracle ††	2,756.0
Schlumberger	3,067.7	+17	351.4	+92	0.56	0.59	+0.03	Sanmina-SCI †	3,252.0
3M	5,091.0	+8	720.0	+16	0.91	0.91	—	Sun Microsystems ††	2,843.0
Tyco International †	10,065.0	+4	741.0	+3	0.42	0.42	—	Texas Instruments	3,153.0
United States Steel	3,890.0	+49	462.0	NM	2.71	3.44	+0.73	UTILITIES & TELECOM	51,393.0
United Technologies	9,838.0	+15	650.0	+11	1.27	1.29	+0.02	AT&T	7,273.0
Weyerhaeuser	5,886.0	+14	199.0	+116	1.15	1.07	-0.08	BellSouth	5,146.0
Wyeth	4,648.2	+7	-1,764.3	NM	0.67	0.64	-0.03	Constellation Energy Group	3,285.0
SERVICES	202,433.1	+19	21,179.1	-6	0.77	0.78	+0.01	Dominion Resources	3,761.0
American Express	7,771.0	+10	896.0	+15	0.70	0.71	+0.01	Exelon	3,378.0
AMR	4,541.0	+3	-387.0	NM	-3.18	-2.94	+0.24	SBC Communications	10,287.0
Bank of America	18,263.0	+49	3,849.0	+41	0.94	0.94	—	Verizon Communications	18,263.0
Burlington Northern Santa Fe	2,978.0	+20	347.0	+54	0.78	0.91	+0.13		
Citigroup	28,605.0	+18	5,321.0	+12	1.01	1.02	+0.01		
Delta Air Lines	3,641.0	+1	-2,206.0	NM	-5.51	-5.88	-0.37		
Disney (Walt) †	8,666.0	+1	723.0	+5	0.29	0.34	+0.05		

† First-quarter results †† Second-quarter results
Quarterly sales and profit data provided by
Call. Quarterly profits are income from continuing
operations for a particular company, which differs from con-

that investment is boosting a range of sectors—from technology to transportation to materials. Microsoft Corp. Oracle fared especially well, as information officers opened their wallets. Shipping firms also benefited from a pickup in demand. FedEx Corp. reported sales of \$7.3 billion, compared with \$5.9 billion for the same period in 2004. For a look at how various companies are performing—from the S&P 500 and the broader corporate world—the accompanying table.

What's ahead? Thomson First Call estimates that profit gains may slip to 1% in the first quarter of 2005, in part because growth has been so strong over the past year and comparisons will be tougher going forward. J.S. companies should continue to lead ahead. ■

—By Adrienne Carter in Chicago

% CHG.	THOMSON FIRST CALL DATA		
	ANALYSTS' EST. EPS	REPORTED EPS	DIFF.
+289	1.27	1.25	-0.02
+6	1.47	1.47	—
+23	2.32	2.36	+0.04
+2	0.66	0.70	+0.04
-11	0.68	0.64	-0.04
+217	0.46	0.45	-0.01
-12	0.91	0.98	+0.07
-2	1.11	1.19	+0.08
+18	1.01	1.09	+0.08
-86	1.66	1.76	+0.10
-17	0.08	0.07	-0.01
+9	0.57	0.56	-0.01
NM	-5.41	-4.77	+0.64
-76	0.84	0.88	+0.04
+1	0.76	0.76	—
+46	1.08	1.09	+0.01
+32	0.98	0.99	+0.01
+10	1.06	1.04	-0.02
+36	0.29	0.31	+0.02
+368	0.49	0.70	+0.21
+649	0.77	0.92	+0.15
+12	1.76	1.81	+0.05
-2	0.31	0.33	+0.02
-49	0.04	0.04	—
+124	0.33	0.35	+0.02
+56	0.24	0.27	+0.03
+32	0.14	0.16	+0.02
+55	0.10	0.09	-0.01
NM	0.01	0.01	—
-4	0.26	0.28	+0.02
+433	0.51	0.52	+0.01
+84	0.57	0.78	+0.21
-41	0.41	0.35	-0.06
+13	0.80	0.79	-0.01
NM	1.29	1.22	-0.07
+32	0.64	0.58	-0.06
-15	0.33	0.34	+0.01
NM	0.64	0.64	—

Estimated EPS and reported EPS provided by Thomson First Call. First Call EPS uses the analyst-preferred calculations and could exclude unusual gains or losses.

INFORMATION TECHNOLOGY

FOR TECH, THE END OF A LONG, COLD WINTER

Companies are starting to open their wallets for cheaper, more powerful gear

NOT LONG AGO, TECHNOLOGY companies could barely get chief information officers to return their calls. CIOs were too busy cutting bloated budgets to think about buying new hardware and software. Besides, there wasn't much out in techland to whet their appetites.

Now tech suppliers are expressing cautious optimism that corporate wallets are opening up again. A year-end surge in demand by businesses propelled U.S. spending on information technology up 12.3% last year, to \$484.3 billion, the Commerce Dept. reported Jan. 28. That tops even the peak reached in 2000, at the height of the dot-com boom, and marks the first year of double-digit growth since those heady days. Across techdom, companies have been logging stronger-than-expected results, from bellwethers Microsoft and IBM on down. "The technology sector is back in growth mode," says Caris & Co. analyst Mark Stahlman.

LACKLUSTER SECTORS

WILL THE RECOVERY LAST? Most analysts agree that global tech spending will continue to grow in '05, although estimates range from 4% to 8% amid worries that intense competition and increasingly demanding customers could pressure revenues. Some areas will be lackluster: Revenues in the mature PC sector are expected to grow just 3.7%. Chipmakers could also face a tough year as their customers continue to work down inventories, blunting sales.

Still, after three years in which companies mostly bought gear to lower their costs, businesses are investing in innovations they believe will help them grow. "IT

expense is not going to be coming down," says Robert P. DeRodes, CIO at Home Depot Inc. This year he'll boost tech spending 9%, to \$600 million, on gear that should increase sales volume by streamlining distribution and procurement. "We've got wind in our sails," he adds.

It helps that tech suppliers have revamped their products to satisfy customers demanding more bang for the buck. Inexpensive storage devices are letting companies load up on much-needed capacity without breaking the bank. With the savings, they're adding sophisticated software to manage those piles of

data efficiently. Sales of No. 1 EMC Corp.'s three cheapest products leapt 46% in the fourth quarter, while storage-software leader Veritas logged 14% revenue growth. Meantime, pricey Unix servers acquired in the late 1990s are being replaced with nimbler, less-expensive machines running Microsoft Windows or open-source Linux. In

2005 sales of servers priced between \$5,000 and \$10,000 should grow 17%, the fastest server category, according to research firm Gartner Inc.

A few killer apps have even emerged. Security software and handheld e-mail devices are becoming must-haves in the corporate world. And phone companies are scrambling to replace aging networks with Internet setups so they can offer video and data services. Scott Kriens, CEO of router maker Juniper Networks Inc., which raised its earnings guidance for the first half of '05 from \$860 million to about \$890 million, says: "There's real money being spent—and real money being made." That may be the best news of all. ■

—By Andrew Park, with Brian Grow in Atlanta and Steve Hamm in New York

TECH REBOUND

U.S. corporate tech spending growth



COMMENTARY

BY ROGER O. CROCKETT

Can This Colossus Make Money?

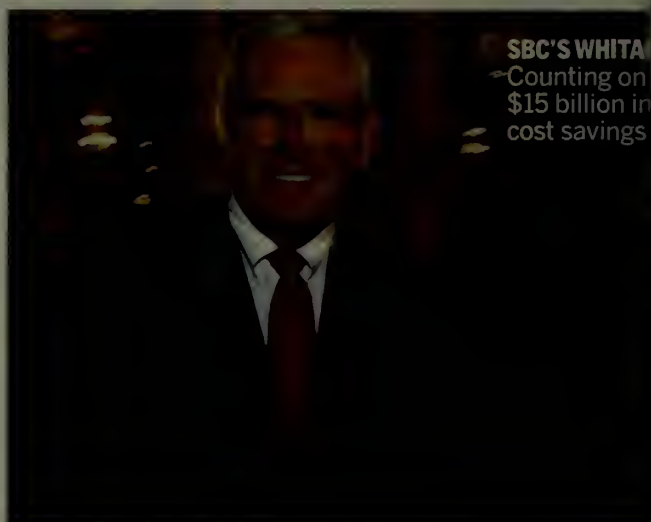
The SBC-AT&T combo has lots of hurdles and little room for error

TO LISTEN TO execs at SBC Communications Inc. tell it, the company's \$16 billion acquisition of AT&T is an obvious coup. The San Antonio local-phone giant gets AT&T Corp., the nation's preeminent long-distance network. Along with it comes a who's who of business clients, not to mention enough savings—\$15 billion—to virtually pay for the deal. No wonder SBC CEO Edward E. Whitacre Jr. calls the deal “a great opportunity.”

Not so fast. No doubt this deal gives SBC, which had revenues of \$52.7 billion in 2004, tremendous scale, making it the country's largest telecom with an estimated \$85 billion in 2006 revenue, according to Standard & Poor's. But there's a lot more to success than sheer size. AT&T, with revenues of \$30.5 billion in 2004, is a business in serious decline. Achieving those cost savings without disrupting operations will depend on flawless integration of complex systems. And SBC's management is already stretched as it works to blend a series of earlier acquisitions, including last year's \$41 billion combo of Cingular Wireless, a unit jointly controlled by SBC and BellSouth, with AT&T Wireless. Most critical of all, SBC must reverse AT&T's shrinking revenues and squeeze new growth out of its own operations. “There are a lot of issues that can go wrong,” warns Todd Rosenbluth, telecom services analyst for Standard & Poor's.

So just how weak is AT&T? In 2006, when the deal should close, AT&T's revenues are expected to slip 9%, to \$23.6 billion, after a 15% drop in 2005; SBC's are likely to grow only 1%, to \$61.3 billion in 2006, after a strong 2005. While Whitacre told *BusinessWeek* “we don't expect to keep losing forever,” many just can't make sense of the deal. “It's a monumentally dumb idea for SBC,” says Scott C. Cleland, CEO of telecom analyst The Precursor Group. “Who wants to be the largest negative growth company in the country?”

No wonder SBC doesn't want to focus



SBC'S WHITACRE
Counting on
\$15 billion in
cost savings

on the bleak revenue picture. Instead, it's highlighting the savings it will reap from the combination: \$2 billion per year starting in 2008 for a total of \$15 billion by 2011. Nearly all will come from trimming a total of 13,000 jobs, or 6% of the workforce.

Reducing head counts at that scale, though, can be tricky. Whitacre got into trouble with consumer advocates and regulators after his late '90s acquisition of Ameritech because he

chopped so many jobs that regulators said it began to harm service. And SBC has to be careful not to make the same mistake it has made in the past by quickly showing key executives the door. AT&T chiefs like David W. Dorman and CTO Hossein Khatibi, not to mention heads of Internet business and enterprise service teams, have knowledge and relationships that SBC desperately needs. If they leave, profits will walk out with them.

It also will take a lot more than whittling jobs to get the cost savings SBC is counting on. Whitacre and team will have to tackle the complex task of integrating the two companies' differing network systems. That will involve condensing a patchwork of 20 disparate billing and customer-service systems down to a common platform and using new technology to tie the systems' services together. The challenge, experts say, comes in building new systems that will allow cross-selling of AT&T

No Slam Dunk

What could make a mess of the merger:

SLUMPING REVENUE Flat sales at SBC and double-digit declines at AT&T mean growth won't come easily.

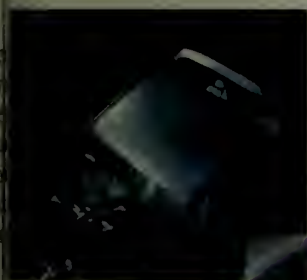
CUTTING COSTS SBC needs to trim \$15 billion in costs to make the deal pay off.

MANAGEMENT OVERLOAD Already busy with previous mergers, SBC execs will have their hands full integrating AT&T's sales force, long-distance network, and IT systems.

BELLSOUTH FACE-OFF SBC will also have to avoid conflicts with wireless partner BellSouth, as SBC encroaches on its home turf.

A Hyundai like you've never seen before.

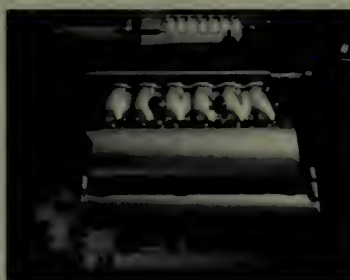
We're investing over a billion dollars here in North America. A new engineering facility in Michigan, a new design and research center and a test track in California. And now, a state-of-the-art assembly plant in Alabama. In the process, we've added thousands of jobs across America. All of it to ensure our unwavering commitment to quality. The result will be a Hyundai like you've never seen before.



One of the world's most state-of-the-art assembly plants now located in Alabama.



All-new designs, inside and out, from our design center in California.



New testing and R&D centers deliver award-winning quality and drive new technology.



Standard-setting safety features, including Electronic Stability Control and six airbags.



HYUNDAI

HyundaiUSA.com

SBC service. "It's never easy," says Larry S. Schwartz, head of global operations for Convergys Corp., which manages billing and customer-service systems.

The goal of all this rejiggering is to create more solid growth prospects for AT&T's \$22.6 billion enterprise unit. The heart of the deal, it sells services to big corporate customers. Reinvigorating it will be key, because SBC needs to counter a flattening revenue base under siege by cable operators like Comcast Corp. But SBC has a long way to go. For starters, it will have to beef up the all-important services that surround its new Internet-based networks. Those include consulting on everything from security to Web hosting. Though relatively small now, Internet-based network consulting is the fastest-growing segment of AT&T's business, expanding some 10% in 2004. Still, the unit only amounts to \$2.3 billion, or 7.5%, of AT&T's revenues. So it better take off fast. Worse, prices for sending Internet data across the country are

falling 8% to 10% a year, estimates Edmond B. Lewis, a partner at telecom consultants RelevantC LLC.

Add it all up, and Whitacre faces plenty of roadblocks with scant room for error. Success will depend heavily on just how fast and

reliably SBC can build its revenue. And that remains the big mystery. SBC hasn't yet released a revenue growth forecast for the combined company, but Whitacre is confident that AT&T's network will add growth. "I think it's a very positive revenue story going forward," he says. He better be right, since those gains will be key to meeting the earnings goals SBC boasts about. In 2008, AT&T's revenue is expected to be about \$20 billion, according to Deutsche Bank Securities Inc. telecom analyst Viktor Shvets. "All it will take is about a 10% miss, and the annual \$2 billion in synergies will be wiped out," Shvets says.

Yet Whitacre figures he's got little choice but to push ahead. In the new era of communications competition, with cable operators unveiling competitive services at every turn, it's grow or get passed by. To succeed, Whitacre and his ambitious team at fast-growing SBC have plenty of hard work ahead. ■

—With Steve Rosenbush in New York

TELECOMMUNICATIONS

SBC Is Edging Onto BellSouth's Turf

Before he decided to gobble up AT&T Corp., Edward E. Whitacre Jr., chief executive of SBC Communications Inc., was hungry for a takeover of another company: BellSouth Corp. And many in the industry figured marrying the two regional Bells made sense. Their customers and phone lines rarely overlap, and a merger would unify ownership of their joint-venture, Cingular Wireless LLC, now the country's largest wireless company. But a deal collapsed when BellSouth's CEO F. Duane Ackerman couldn't come to terms with Whitacre.

Now, what began as a courtship could devolve into something far less friendly. The AT&T deal means SBC will be competing far more aggressively for business accounts deep in BellSouth's territory. If Whitacre is able to lure enough corporate customers away from BellSouth, and package that business with Cingular's wireless service, SBC could gain more sway over the direction of Cingular. And given that Whitacre has already said he wants to own it all, tension with BellSouth is sure to grow. "As soon as SBC buys AT&T, they become BellSouth's No. 1 competitor," says Deutsche Bank telecom analyst Viktor Shvets. "I can't see how friction won't increase incrementally."

For both Bells, the stakes are high. The wireless unit, 60% owned by SBC but with senior management and the board equally divided between its two parents, is the crown jewel of both. Cingular's revenue grew 25.5% last year, to \$19.4 billion, while sales of traditional phone services at the two companies were flat. At BellSouth, Cingular is expected to contribute 39.9% of this year's estimated revenues of \$33.6 billion, up from 27.6% in 2004. At SBC, meanwhile, wireless will produce 31.5% of estimated sales of \$60.7 billion, up 9.4% over last year. "If you ain't in wireless, you ain't in business," says Mark A. Winther, telecom analyst at research firm IDC.

BellSouth executives deny any tension with SBC and insist they are committed to the Cingular joint venture. BellSouth also says its 50% control of Cingular's management and board mean it has equal sway



CINGULAR The prize both are after

over any moves by SBC. Moreover, BellSouth execs argue that the SBC-AT&T merger will help them because 40% of all Cingular revenues coming from the new combination's corporate customers will go straight into BellSouth's pocket.

Still, the SBC-AT&T merger leaves BellSouth more boxed in to its nine-state Southern region, unable to offer business customers a national network comparable to SBC's. BellSouth execs argue they don't need one; for now they're content to rely on hefty margins of 22.5% in one of the fastest-growing regions in the country.

Since announcing the deal on Jan. 31, Whitacre has been careful to downplay any potential for a rift. "I don't think the relationship will be soured," he told analysts at a conference call on Monday. Yet industry experts see a ticking time bomb. The issue will come to a head, they say, in the next few years if SBC begins to poach enough overall revenues from big companies to outweigh BellSouth's share of those sales from Cingular. When that happens, the company may have to rethink its strategy.

One option: BellSouth could extract a huge paycheck from SBC to purchase its share of Cingular, then use the cash to buy the third-largest cellular player, Sprint Corp., which is poised to merge with Nextel Communications Inc. BellSouth says it's not planning a bid, but it has tried to buy Sprint in the past. Whatever happens, SBC and BellSouth's once cozy partnership has changed for good. ■

—By Brian Grow in Atlanta

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Figures as of 12/31/04	1 Year	5 Year	10 Year
Balanced Fund	10.32%	3.78%	10.11%
Lipper Balanced Funds Average	7.93%	2.01%	9.09%
Capital Appreciation Fund	15.29%	14.40%	13.95%
Lipper Multi-Cap Value Funds Average	14.39%	5.36%	11.86%
Equity Income Fund	15.05%	7.67%	13.00%
Lipper Equity Income Funds Average	12.81%	4.17%	11.13%
Growth Stock Fund	10.24%	0.15%	12.21%
Lipper Large-Cap Growth Funds Average	7.18%	-8.22%	8.55%

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AEROSPACE

MARINE ONE, SIKORSKY ZERO

Losing the Presidential chopper is a blow—and not the only one for UTC

A FEW MONTHS AGO, George David refused to contemplate a future without a U.S. President flying in a Sikorsky helicopter. United Technologies Corp.'s chairman and CEO knew that the unit was facing stiff competition for its bid to build the next-generation Marine One. Still, he jokingly vowed to jump out of a flying helicopter if UTC didn't snag the deal. "It's win or drop dead," David declared.

Oops. On Jan. 28 the U.S. Navy awarded the coveted 9-year, \$6.1 billion contract to Lockheed Martin Corp. and suppliers led by Anglo-Italian copter maker AgustaWestland Inc. David didn't jump—and Sikorsky Aircraft Corp. President Stephen Finger said that, while disappointing, the Marine One loss didn't dim the bright future of the S-92 chopper, the design on which the Marine One H-92 bid was based. Even without Marine One, which Sikorsky has made for almost half a century at its Stratford (Conn.) plant, "we are focused on doubling our business

by 2008," to \$5 billion, said Finger. The S-92 and H-92 have won several competitions against AgustaWestland's EH-101 since being certified two years ago, including selection by the governments of Canada, Turkey, and Turkmenistan.

Even if Sikorsky can double sales, which analysts agree is probably doable, nothing matches the prestige of the Presidential chopper. What's more, the Navy's rejection is just the latest in a series of high-profile blows to Sikorsky and its \$37 billion Hartford parent. In the past year, sister unit Pratt & Whitney lost a coveted bid to provide jet engines to Boeing's 7E7 Dreamliner—a deal worth as much as \$40 billion over 25 years. Rivals General Electric Co. and Rolls Royce PLC got the nod instead. Add to that the Army's cancellation of the \$39 billion Comanche helicopter program.

SOUTH LAWN
Bush's future
copters will come
from Lockheed

The net resu
korsky's share
\$5 billion glob
copter market
17.1% in 2004

below the 38.9% share it held b
1990, according to Teal Group Corp.
larly, Pratt has lost its groove in the
commercial jet engine market, h
gone from market dominance 30 yea
to being a marginal player on new o

BLACK HAWK UP

WHY THE STRING of big losses? Th
sons vary from David's refusal to
prices on the 7E7 jet engine—a
lauded by shareholders—to the fail
understand the priorities on the Pres
tial bid. In the case of Marine One, b
believe Sikorsky underestimated the
for greater size, speed to market, ar
cus on communications technology
bid. "The helicopters [themselves
now a commodity," says Teal Gr
Richard L. Aboulafia. While Sik
teamed up with L-3 Communica
Holdings Inc., which handles com
cations for Air Force One, Lockheed
the edge in systems integration—the
ity to stitch together computers, con
nications systems and sensors. Mor
portant, perhaps, the EH-101 had a lo
track record and was ready to go.

As for Pratt, industry observers v
that it lacks the deep pockets and
products to compete on large comme
engine orders. Nevertheless, it is a le
in the military and regional jet ma
And with its reported move to buy
ing's Rocketdyne rocket-engine busi
for more than \$500 million, Pratt air
bolster its presence there.

Clearly, UTC has some tough decis

ahead. Sikorsky still m
the ubiquitous Black H
but may face a tougher
de persuading custome
buy its new S-92 cho
in the face of the Presi
tial slap. It's consider
top contender for the
mated \$8 billion cont
to supply 132 search-
rescue aircraft to the
Air Force. Meanwhile, I
may decide to focus its
ergies increasingly on r
tary contracts and smal
gional craft.

So there's no need for David to ju
out of a chopper. But the Marine One
should give him plenty to think about

—By Diane Brady in New Y
with Stan Crock in Washing

THE STAT

17%

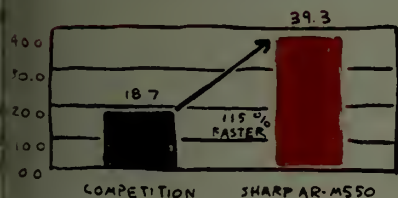
Sikorsky's share of
global helicopter
sales, down from
39% in 1990

Data: Teal Group

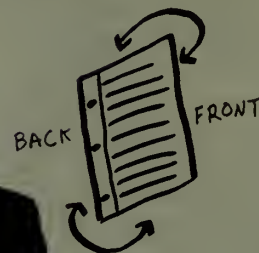
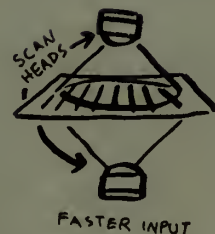
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News In Biz This Week

EDITED BY MONICA GAGNIER

HEADLINER

KEN CHENAULT



DEALING OUT THE CARDS

American Express CEO **Kenneth Chenault** has one word for investors: Plastic. By spinning off the less-profitable brokerage and money management unit to shareholders later this year, Chenault is returning AmEx to its core card and payments business—credit cards, corporate travel and entertainment cards, and reloadable traveler's checks. "If you don't have focus, you're at a competitive disadvantage," Chenault said. That's an about-face for an outfit that helped kick off the era of financial supermarkets by buying the predecessor of American Express Financial Advisors back in 1984. Investors like the new strategy, though. They pushed shares up 6.5%, to 56.75, on Feb. 1.

Chenault's plastic focus got a boost on Oct. 4, when courts struck down Visa USA and MasterCard International rules banning U.S. banks from issuing rival cards. AmEx' new partners, credit-card issuers MBNA and Citigroup, are expected to put thousands of new cards in the market this year. Charge!

—Mara der Hovanesian

GOOGLE'S BOODLE

Google continues to raise investor expectations about the potential of the Internet search business. On Feb. 1, the Mountain View (Calif.) search giant blew past its fourth-quarter expectations, thanks to accelerating revenue and profit growth. The company tallied \$204 million in net profits for the quarter, on \$654 million in net sales. More marketers have piled into the booming business of search ads, fueling a rise in the price that online advertisers pay for certain search terms. The earnings results made for a frenzy in Google's stock, despite **Microsoft's** launch of its competing search engine, which was also unveiled on Feb. 1. Google shares rose 7%, to \$205.96, on Feb. 2.

MARSH MAC SETTLES UP



Marsh & McLennan, the world's largest insurance broker, agreed to settle civil fraud charges on Jan. 31 for a record \$850 million, though it did not admit or deny guilt. The charges were brought on Oct. 14 by New York Attorney General **Eliot Spitzer**, who is still targeting insurers **Aon**, **Ace**, and **American International Group**, among others. As part of the deal, Marsh is banning

"contingency fees"—money received for steering business to certain insurers—and other practices such as "tying," when insurers obtain business by promising to pay for services of other Marsh divisions. Spitzer isn't gunning for changes at just Marsh. He has said that his goal is to reform the entire culture of insurance brokering.

ADELPHIA TUG-OF-WAR

New Jersey financier **William Huff** could hold the key to who ultimately wins control of bankrupt **Adelphia Communications**. Through bond holdings, Huff, 54, owns about 17% of the nation's fifth-largest cable operator. Cable giants **Comcast** and **Time Warner** jointly offered \$17 billion for Adelphia's 5 million subscribers in a Feb. 1 auction. Private equity firms **Kohlberg Kravis Roberts** and **Provident Equity Partners** jointly bid \$16 billion. Huff has said he wants \$17.5 billion or more for the cable operator or will block any sale. Huff, who leads a group of Adelphia bondholders, could force bidders to raise their offers or persuade them to accept bonds as equity in a new company, sources say. Adelphia, which lost nearly 250,000 subscribers in 2004, has said it wants to sell the company whole or in parts within the next few weeks.

FORD FALLS BEHIND

January was icy indeed for **Ford Motor**, as sales dropped 5%. Meanwhile **Chrysler Group** posted a 9% gain, and **General Motors** eked out a 1% increase; overall, industry sales rose 2%. Ford's

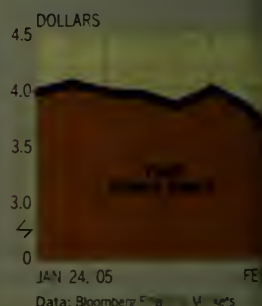
Explorer and Expedition sport-utility vehicles too hits, and sales fell 33% a Jaguar unit. Even sales of popular F-series pickup trucks dropped 13%. An also fretted that sales for trio of new family cars F launched last fall—the F Five Hundred and Frees and the Mercury Montego haven't been picking up momentum.

ET CETERA...

» **NewsCorp** reported an 80% gain in quarterly earnings on strong film sales
» **Computer Associates** named former Dell exec Robert Davis as its new CEO
» **Martha Stewart** will star in a version of *The Apprentice*

CLOSING BELL

TiVo investors hit rewind when the president quit on Feb. 1, a week after the CEO stepped down. The digital-video-recorder pioneer is under fire, as cable and satellite operators offer cheaper DVR service. TiVo shares fell 10.7%, to \$3.58 in the two days ended Feb. 2.





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SOURCING

PROCUREMENT

SUPPLIERS

EDITED BY RICHARD S. DUNHAM

Seeing Red Over Big Blue's China Deal

WHEN THE JAPANESE were awash in dollars in the '80s from a growing trade surplus with the U.S., their purchase of one of America's crown jewels—Rockefeller Center—set off howls of protest. Now the Chinese, with a pile of greenbacks from an even larger trade imbalance, are creating a ruckus in Washington by buying a piece of another U.S. company, IBM.

Unlike the noisy but impotent response to the Rockefeller Center deal, however, the Chinese purchase has prompted a government panel, the Committee on Foreign Investments in the U.S., to probe whether Lenovo Group's \$1.25 billion purchase of IBM's PC business might imperil national security.

Several agencies, which sources say include the Homeland Security Dept. and the FBI, have expressed concern that the sale could help China's military. One of the issues is the possible transfer of encryption technology. Another fear:

the proximity of higher-end operations in Research Triangle Park (N.C.) to the Lenovo will buy, which could make industrial espionage easier.

The probe was requested by three powerful House Republicans, including International Relations Committee Chairman Henry J. Hyde (R-Ill.), Armed Services Committee Chairman Duncan Hunter (Calif.), and Small Business Committee Chairman Don Manzullo (Ill.). "It is important, Hunter says, but 'the security concern is overriding.'"

These Shopping Spree?

THE IBM DEAL could be just the start of a frenzied buying binge by China as it recycles an estimated \$400 billion in dollar reserves. Right now, Uncle Sam can kill a deal only for national security, not economic reasons. "It may be appropriate to look at a broader model," says William A. Wessels, president of the National Foreign

Trade Council, a business group that promotes trade.

To strengthen its hand, IBM has hired a lobbyist who once worked for Senate Majority Leader Bill Frist (R-Tenn.) and legal powerhouse Covington & Burling. But even some hard-liners on China doubt that the deal poses a risk. Unlike companies with close ties to the Red Army, Lenovo "is not an arm of the Chinese military," says Larry M. Wortzel, an Asia expert at the Heritage Foundation. And to assuage concerns, IBM could wall off certain operations in North Carolina to prevent leakage. A spokesperson says IBM remains "confident in the process and its outcome."



HYDE is among three GOP power brokers who ordered a probe

Some experts have broadened concerns about a Chinese shopping spree. Michael R. Wessels, a Washington consultant and member of the congressionally appointed U.S.-China Economic & Security Review Commission, fears that unlike Japan, China won't invest in the U.S. and bolster the American economy but will take the technology and run. Wessels says that happened after the 1995 purchase by Chinese companies of Anderson (Ind.)-based Magnequench, which made railroad magnets used in the guidance system of smart bombs.

A lot of people in Washington "are suspicious of selling anything remotely useful to the Chinese," notes Reinsch. Some of those suspicions stem from the leakage of technology to China in the 1990s and recent sanctions against Chinese companies for selling gear to Iran. The IBM sale may go through, but experts expect the U.S. to cast a more skeptical eye on future deals with China. ■

—By Stan Crock

CAPITAL WRAPUP

THE CHAMBER STEPS UP ITS WAR ON THE SEC

THE U.S. CHAMBER of Commerce is opening new fronts in its legal battle with the Securities & Exchange Commission. On Jan. 18, the Chamber filed a friend-of-the-court brief in support of Siebel Systems, which the SEC has charged with violating a 2000 rule that bars companies from selectively disclosing material information. The Chamber is challenging the SEC's legal authority to impose the fair-disclosure rule, known as Reg FD, and argues that it infringes on execs' freedom of speech and association. The Chamber had already sued the agency in U.S. District Court last September seeking to overturn a rule requiring chairmen of mutual-fund boards to be independent of the fund's investment adviser. Next up: The Chamber may file a brief supporting a hedge-fund manager's suit to overturn the new SEC requirement that hedge-fund advisers register with the SEC.

A DWINDLING CORPORATE TAX TAB

AS WASHINGTON shifts more costs to states—witness the Medicaid cuts expected in President Bush's 2006 budget (page 30)—liberals worry that states' antiquated tax systems can't bear added costs. Fueling those fears: a new study charging that Corporate America is slashing its state income tax tab. In an analysis of 252 large, profitable companies, Citizens for Tax Justice found states reaped 2.3% of profits in 2003—down from 2.9% in 2001 and far below the states' official tax rates, which averaged 6.8%. The labor-backed CTJ says total state collections from corporate income taxes have fallen 40% since 1989.

FINLAND

WILL REWIRING NOKIA SPARK GROWTH?

CEO Ollila's plan for the phone giant: Go after both economies of scale and innovation

TERO NAUMI HAS A JOB any couch potato would love. The 40-year-old Nokia Corp. engineer watches television eight hours a day. As product manager for Nokia's mobile-TV technology, which will let handsets receive a dozen channels of digital TV starting next year, Naumi spends workdays in his cubicle viewing the news and soap operas on a specially equipped Nokia 7710 phone, which features a 3-inch wide screen and sells for \$650 before subsidies from phone carriers. Sometimes he tools around Turku, some 90 miles west of Helsinki, in a van to test reception in hard-to-reach places.

Digital television on handsets is just one of the far-out schemes the world's largest mobile-phone maker is hatching to resurrect flagging growth. At a Nokia development lab near Vancouver, programmers are writing new video games that let thousands of players battle each other over the airwaves using Nokia's N-Gage wireless game console. Engineers in Boston and Tampere, Finland, are busy weaving new e-mail readers and security software into Nokia's handheld Communicators—pint-size hybrid phone-PDAs aimed at corpo-

rate customers. "Nokia is a beehive of experiments these days," says John Jackson, senior wireless analyst for telecom market researcher Yankee Group in Boston.

BATTLE STATIONS

THE FINNISH PHONE giant has little choice but to wade into new waters. Although the company sold an amazing 208 million handsets last year, up 16% from 2003, fierce competition and sagging prices pushed mobile-phone revenues down 3%, to \$30 billion. Nokia also had a wretched first half in 2004, when a stale product portfolio and strained relationships with mobile operators cost it nearly a fifth of its hard-won 35% global market share and pushed revenue growth into reverse. Dismayed investors pounded Nokia's stock down to a 12-month low of \$11.03 in New York on Aug. 13—52% off its peak in March.

To get Nokia back on track, chief executive

Jorma Ollila has cranked up the introduction of new phones, especially "clamshell" models that hinge at the top. He has agreed to tailor phones to client specifications more than ever before. And to regain lost share, Nokia slashed prices on certain models by up to 25%, at the expense of operating earnings, which fell 15% in 2004, to \$5.6 billion. By yearend, Nokia had managed to claw back nearly all its lost market share, according to market researcher Strategy Analytics. In late January the company turned in fourth-quarter sales and earnings that beat Wall Street estimates. And its stock recovered to finish 2004 down just 7%.

But Nokia still faces a fundamental problem—no growth. Nokia's line has been drifting down by an average of around 1% annually since 2000, hit \$38 billion last year, while net profits have fallen 18.6% in the same period. In comparison, rival Samsung Electronics has seen mobile-phone sales and profits triple over the last five years, while Motorola Inc. endured deep losses before a dramatic turnaround.

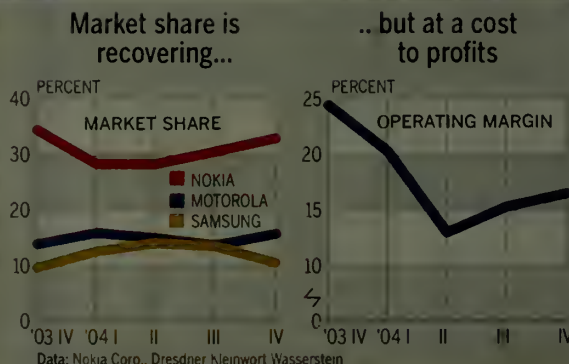
To get Nokia's engines revving again, Ollila is redirecting research and development to areas where Nokia stands apart, especially radio technology and mobile-phone software. Nokia spent more than \$4.8 billion last year on R&D. At 12.8% of revenues, Nokia's spending was three percentage points higher than Motorola and about twice the R&D ratio of Sony Corp.

But the strategy carries huge risks. Nokia is racing into unfamiliar markets which could bring it into competi-

NOKIA 7710
It's a phone, camera, music player, and—soon—a TV



NOKIA'S TRADE-OFF





FORMER
has redirected
spending

the likes of Microsoft Corp. and Apple Computer Inc. Some efforts are not panning out. Nokia's Communicator, for instance, has never enjoyed the popularity of Palm and PocketPC PDAs, though the newest models are getting a better response. Nokia's N-Gage wireless game console has sold 1.3 million units, far below expectations. Meanwhile, products like the ultra-thin Razr V3, which makes many a Nokia handset look dumpy in comparison. "Innovation is absolutely the top priority for Nokia," says Chief Technology Officer Jarmo Ollila.

Nokia itself still relies on basic cell phones for 63% of revenues and 87% of operating profits, though their contribution is likely to decline as new initiatives take on. Another division, accounting for 10% of revenues, sells wireless networks to operators. Two new divisions handle

multimedia devices—camera phones, game machines, and mobile TV—and business devices that require higher levels of R&D and market development.

The new structure better reflects the changing industry. Because of market saturation in the developed world, analysts expect total handset shipments to grow only in the single digits for the next few years. To compensate, Nokia is diving into China, India, Brazil, and Russia, which are growing much faster than Europe or North America.

At the other end of the scale, Ollila is casting a wide net for high-margin opportunities outside conventional handsets, especially in the hotly contested "convergence" arena. Nokia's new multimedia group, for instance, offers gadgets

that take pictures, play games and music, and will eventually show digital TV. The group booked revenues of \$4.7 billion last year, up 46%, and earned its first operating profit of \$232 million.

To court business users, Ollila has also established an "enterprise solutions" group. The goal: persuading companies to outfit their workers with voice-and-data gizmos such as the \$1000 Nokia Communicator, which looks like a phone when folded shut but opens up to reveal a keyboard and wide color screen. The enterprise group topped \$1 billion in revenues last year, up 57%, but will likely continue losing money through 2005.

"MORE CONVINCED THAN EVER"

BROKERAGE CREDIT Suisse First Boston figures the new businesses will boost Nokia's top line by \$2.6 billion this year, enough to compensate for a \$1.7 billion decline in sales of conventional handsets. "I am more convinced than ever that the reorganization was right," Ollila says.

The next step in Ollila's transformation is to exploit Nokia's technology assets to revamp the way it builds handsets. Already, phones can be built by snapping together modules of chips and radios to accommodate different wireless standards and feature sets. Yet until now, Nokia's older phones, as well as those of rivals, had to be painstakingly reworked to accommodate a software change as simple as moving the photo messaging feature from the main menu to a special section devoted to imaging. Now, with

new standardized software the company has spent years developing, engineers can make the change in a matter of days—and send the modification to the factory to be burned into thousands of phones.

Nokia's new modular hardware and flexible software makes it easier for the company to customize products faster. With its new 6630 3G phone, for instance,

Nokia created entirely different menus and screens for Vodafone Group PLC and Orange. Nokia also aims to speed the latest technology to the marketplace by producing smaller batches of some new phones. Faster. Smarter. More flexible. It's the new Nokia. But those gadgets better be what customers want. ■

—By Andy Reinhardt in Helsinki,
with Moon Ihlwan in Seoul

Ollila intends to buoy the top line with a wave of cool handsets

BRITAIN

THE REEDUCATION OF OXFORD

Can John Hood, the university's new head, put its finances on a sound footing?



RICH IN HERITAGE
Needed: A fatter endowment

MENTION OXFORD, and images of daydreaming dons and youths punting on the Cherwell come to mind. But in the sparsely furnished office of the university's new boss, Vice-Chancellor John Hood, the talk is all cold facts and figures. Hood doesn't even blush when he compares managing Oxford University's 2,000 or so research projects to running a construction company—something he once did. “Exactly the same discipline is required to manage that scale of activity,” he says.

The university committee that hired Hood, 53, last October, broke with hallowed tradition in several respects. Hood, who attended Oxford on a Rhodes Scholarship, is a New Zealander and the first Vice-Chancellor in the university's 900-year history to come from outside its aca-

demical ranks. (The Chancellor, currently Chris Patten, is traditionally a figurehead.) Hood also brings an unusual amalgam of experience in both business and university administration. He ran the construction and paper divisions of Fletcher Challenge Ltd., a New Zealand conglomerate, before becoming Vice-Chancellor of the University of Auckland in 1999. His message: Oxford needs to get its financial and adminis-

THE STAT

\$17,139

The annual budget shortfall at Oxford University for each undergraduate

Data: OxChaps

trative houses in order if it is to remain the top tier of the world's universities forget about government coming to rescue. “We cannot think of our future lying in the hands of public funds,” Hood says.

Hood wants Oxford to have the resources to challenge such preeminent universities as Harvard and Princeton—going after top American undergrads something Oxford doesn't do now. If he succeeds, he could be a forceful advocate for revolutionizing the way European universities run their universities. On the Continent as well as in Britain, higher education suffers from an acute funding crunch.

TOO MUCH RED INK

BUT HOOD WON'T HAVE an easy time. He has to remain on good terms with the government, which still provides about 30% of Oxford's \$860 million revenues, but is moving toward greater independence. Higher education is an explosive subject in Britain, as shown by last year's bruising fight to raise annual tuition fees from \$2,100 to \$5,600 starting in 2006—a figure that won't come close to eliminating Oxford's \$17,000-plus budget shortfall per undergraduate each year. (The shortfall at American Ivy League schools is much greater, but they spend roughly three times what Oxford does on educating an undergraduate, according to OxChaps, an Oxford think tank.) Tuition and government funding cover only about half of the \$35,000 cost of educating an Oxford undergraduate each year. The university tries to make up the rest with income from the Oxford University Press, high-tech spin-offs, and its relatively small endowment. But it still runs a \$36 million annual deficit.

Building up the university's endowment, 80% of which is held by the 39 independent colleges, is central to Hood's plan. With about \$3.7 billion, Oxford's funds are dwarfed by Harvard University's \$22 billion and Stanford University's \$13 billion. He has hired a development officer, Peter Dellandrea, from the University of Toronto in the hope that Oxford can acquire a bit of North American fund-raising magic. One of Dellandrea's key tasks will be to juice the level of alumni giving: Harvard brings in more than \$500 million a year, while Oxford raises just \$150 million.

Hood may also transfer management of the endowment from outside firms to an in-house team. Up till now, it has been earning returns of around 6.5%, compared with 15.9% annually over the last decade for Harvard. Supporting those donors, Hood says, isn't going to get any cheaper.

—By Stanley Reed in London

A dramatic photograph of a helicopter hovering over a turbulent ocean. The helicopter is silhouetted against a bright, hazy sky, and a person is being hoisted from the water by a cable. The water is dark and choppy, with white foam from the helicopter's wake.

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FUZZY NUMBERS NO MORE?

Statistics could improve if Beijing's new economic census is a success

BEIJING THIS WINTER IS festooned with orange banners and billboards that look like Communist agitprop. But instead of slogans exhorting hero-workers to produce more rice or steel, the message reads: "The economic census needs your support!" Time was, China's central planners would have known how much of everything Chinese companies were churning out. But now, China is marshaling millions of T-shirted recruits to query business owners about their sales, profits, and production.

Will China's new capitalist roaders reveal such sensitive information? The first results won't come out until August, but the census is so important for the government that it has pledged not to use the data to track down tax evaders. Beijing hopes the census will help it better understand the \$1.4 trillion economy—and improve the quality of Chinese statistics, which many experts have long decried as grossly inaccurate. "We consider the criticism from home and abroad an impetus

to speed up our statistical reform," Li Deshui, commissioner of China's National Bureau of Statistics (NBS), said at a conference on Jan. 17.

Just about everybody would benefit from better numbers out of China. The country sucked in some \$65 billion in foreign direct investment last year, overtook Japan as the world's No. 3 trading nation, and amassed more than \$600 billion in foreign currency reserves. The price of oil, steel, aluminum, copper, and iron ore all turn on the economic figures China releases.

Until recently, though, China's statistics were about as reliable as a \$19 DVD player. After the 1997-98 Asian financial crisis, economists say, Beijing exaggerated its expansion to show how well it was withstanding the

fallout. These days, China is getting for underreporting growth. Private economists think the country grew by more than 10% in 2004 despite the 9.5% released on Jan. 25. Shoddy recordkeeping is partly to blame. But there's also a incentive for local officials to meet—probably—the official growth target set annually by Beijing. "There is political pressure when growth is running hot to err on the negative side and when running slow to err on the positive," says Arthur Kroeber, managing editor of the Hong Kong-based China Economic Quarterly.

HARD-TO-FAKE DATA

SOME EXPERTS ARE taking matters into their own hands. UBS economist Jonathan Anderson creates a growth index using hard-to-fake data including internal trade, air travel, and energy consumption. Official figures show Chinese consumer spending last year robust (fueling 13% growth in retail sales), rural incomes rose sharply, and investment jumped 26% for the whole economy. "Put those pieces together and it is very difficult to get an economy growing at just 9.5%," he says. The real number, he figures, was 10.6%.

That's not to say there has been no improvement in Chinese statistics. In 2003, China doubled to 700 the number of items it includes in its monthly survey of consumer prices. And to bypass local officials who might be inclined to fudge economic performance to move up the ranks, the NBS now collects data directly via the Internet from 5,000 large and midsize companies, accounting for nearly half of China's industrial production.

The push to add more integrity to

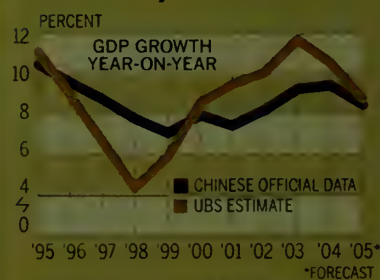
Chinese economic data is a work in progress and the census is a good start. But the real test will come when China's growth is visible in the pop and economic expansion slows dramatically. If Beijing comes out about what's really happening when the numbers are embarrassing, China will prove it has matured. But the government

continues to hide the truth, all the sloganeering around the economic census will be as hollow as the old-time propaganda.

—By Brian Bremner in Hong Kong
Dexter Roberts in Be

SMOKY SIGNALS

China's growth picture is clouded by unreliable data



Data: National Bureau of Statistics (China), Development Research Center (China), UBS Securities

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INDIA

GOOD HELP IS SO HARD TO FIND

Higher wages and lavish perks reign as outsourcing outfits scramble for talent

WHEN INDIAN software services giant Wipro Ltd. hires middle managers these days, it doesn't just negotiate pay and bene-

fits. Instead, the company engages in an elaborate mating ritual that includes helping a new hire find a home and even easing school admissions for the recruit's children. "We have to offer a virtual valet service for them," says Sudip Banerjee, president of enterprise solutions at Wipro.

It's no wonder Wipro has to be more aggressive in wooing staffers these days. The Indian outsourcing industry grew 35% last year as big multinationals and smaller U.S. and European companies alike handed over to Indian companies everything from software development to financial analysis. That growth has boosted entry-level wages by as much as 15% annually over the past two years, while salaries for mid-level managers have clocked 30% annual growth during the same period, to an average of \$31,131, according to Nasscom, India's software industry association.

The quest for workers is creating a talent crunch that some believe might dull India's edge in outsourcing. The industry employs 1 million people in India, but that number is expected to double by 2008, Nasscom says. Although 2 million Indians graduate from college each year, the services industry is suffering a shortage of seasoned professionals. Currently, the industry needs 15% to 20% more mid-

level execs than it can muster. On-the-job training can fill the gap, but it's pricey: Educating a recruit costs up to 40% of a rookie's annual salary. Worse, once newbies get some experience, they're often lured away by rivals.

To some extent, the rising wages are offset by falling costs in other areas. For instance, deregulation and competition have helped cut telecom fees in India by



up to 25% annually since 2002. And as the outsourcing shops provide similar services to a growing pool of customers, they can increase productivity by retooling software written for one client and adapting it for others. Revenue per employee at Indian services players jumped by as much as 18% last year, according to Ravi Aron, a professor at the University of Pennsylvania's Wharton School.

FABULOUS PARTIES

THE CRUNCH IS SERIOUS enough that companies are working hard to keep talented veterans from jumping ship. At Accenture Ltd., top managers spend at least an hour every couple of weeks with software coders and call center operators

to get a handle on shop floor issues. Infosys last year marked a milestone, reaching \$1 billion in revenues—a celebration featuring Indian pop songs and a gala dinner. But it's not just parties. The company also handed out \$10 million in bonuses—\$500 to \$5,000 each worker.

For favored employees, there are lots of opportunities for advancement. Wipro, for example, puts top performers into an accelerated training program and sometimes pays for a certification in project management. Call center operator 24/7 Customer Inc. pays half the \$2,900 annual tuition for employees to earn a business certificate from the Indian Institute of Management in Bangalore. "You can appeal to the careerists with the lure of learning and mobility," says Shanmugam Nagarajan, 24/7's co-founder and chief operating officer. Some companies are even looking to Indian expatriates to fill the management gap. In the past three years, about 200 tech professionals returned to India from abroad, says Nasscom.

Most insiders expect the talent crunch

Wages of Success

India's software outsourcers are paying more for programmers and a lot more for managers

AVG. ANNUAL SALARIES	ENTRY-LEVEL SOFTWARE WRITER	PROJECT MANAGER
2000	\$4,082	\$13,581
2001	4,213	14,651
2002	4,496	16,311
2003	5,852	25,821
2004	6,628	31,131

Data: Nasscom

to be relatively short-lived. Although wages for mid-level managers will continue to rise, many Indian executives say their companies have enough of a profit cushion to absorb increased labor costs. In the meantime, Indian colleges have begun offering courses in tech project management, so in a few years services companies should have an easier time finding qualified recruits. "This is a transition period for the industry," says S. Padmanabhan, global human resources chief at Tata Consultancy Services, India's largest software outsourcing shop. Perhaps in the meantime, good valets may be in as much demand as qualified managers.

—By Josey Puliyyenthuruthel in Bangalore and Manjeet Kripalani in Bombay

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One Giant Step for Iraq, Smaller Steps Elsewhere

THE TELEVISION IMAGES of huge numbers of Iraqis defying insurgents' threats to cast their votes on Jan. 30 were watched across the Middle East—and nowhere more closely than in neighboring Kuwait, which Saddam Hussein invaded in 1990. "The election is a very important sign for us," says Kamel A. Al-Harami, a

Kuwaiti oil consultant. "If the security situation stabilizes and Iraq has a freely elected government, it will be good for Kuwait and, later, the rest of the Arab world."

Those are, of course, big ifs. It remains to be seen whether the Iraqis can parlay their election enthusiasm into an effective government that can quash the insurgency. If they succeed, a tolerant, pluralistic Iraq will turn up the pressure on the region's 1950s-style strongman regimes and monarchies, which are increasingly seen as dead weights on their people and economies. "What you have in Iraq is fundamental change that will have resonance in the rest of the region," says Abdel Monem Said Aly, director of Cairo's Al-Ahram Center for Strategic & Political Studies.

Outsiders may think of the Middle East as a bleak disaster zone, but on the ground there are more than a few signs of a shift, particularly on the economic front. Egypt, Saudi Arabia, and even Syria are taking long-needed measures, from tax cuts to opening the way for foreign investment. The region's stock exchanges are responding: Arab markets were up an average of 74.9% last year, with the 106.8% gain of Egypt's Hermes financial index leading the way.

Why the surge? Most analysts point to local improvements. Egypt's economy is expected to grow 5% over each of the next two years. It's benefiting from growth in tourism and success in exporting food, cement, and textiles. Hassan Heikal, a top investment banker at EFG-Hermes in Cairo, says corporate profits are up some 40% in the last year. Prime Minister Ahmed Nazif, who took office in July, is cutting taxes and looking to

restart stalled privatizations of cement companies and banks.

Opening the Door

SAUDI ARABIA IS also witnessing change. High oil prices were a key factor in pushing the Saudi market to an 85% gain last year. Beshr Bakheet, chief of Riyadh brokerage Bakheet Financial Advisors, also points to soaring profits. But the removal of the incubus of Saddam Hussein hasn't hurt. What's needed now to keep up the momentum is political reform to match the economic change. Saudi Arabia will break from tradition and hold municipal elections in late February. Bakheet is one of hundreds of candidates for the Riyadh City Council. He has a Web site, votebakheet.com, and gives the process a thumbs-up despite a bar on political parties and the failure to grant women the right to vote. "This is a testing ground to open the door to real power," he says.



IRAQI VOTER

The election was closely watched in the region

Baby steps, maybe. But they're taking place all over. New Palestinian President Mahmoud Abbas looks likely to clean out some rotten wood in the Palestinian Authority and is expected to meet soon with Israeli Prime Minister Ariel Sharon. The Tel Aviv Stock Exchange is hitting record levels as investors bet Abbas will end the *intifada*.

Of course, militants or Israeli settlers could scuttle Abbas' efforts, and the news from Iraq also could sour. Iraqis need to match the enthusiasm they showed in voting with a sustained effort to seize control of their destiny. If that happens, the Middle East picture could change dramatically. ■

—By Stanley Reed in London, with Neil Sandler in Jerusalem

GLOBAL WRAPUP

EU COMPETITION CHIEF COMES OUT SWINGING

THE NEW European Competition Commissioner **Neelie Kroes**, is distressing some European Union members by taking a tough line on state aid to industry. Officials from Britain, France, Germany, and Austria wrote to Kroes in early February, expressing alarm she questioned the practice of relatively wealthy EU member states using subsidies to promote development in the depressed areas. Such aid has been key in luring projects such as a Toyota Motor Corp. assembly plant in northern France. A spokesman says Kroes is still consulting with governments. The French are upset by Kroes's threatened legal challenge to a state-subsidized rescue of engineering giant ALSTOM. EU approved the bailout last year, but Kroes said on Feb. 2 that France failed to honor a condition such as opening the national rail system to more competition.

A CLEANUP FOR GERMAN FOOTBALL?

ALLEGATIONS THAT referees took bribes to influence the outcome of German football games could lead to stricter regulation of the sport, which largely writes its own rules. Berlin prosecutors said on Feb. 2 that some 25 referees, players, and others manipulated games in return for bribes from a Croatian crime syndicate, causing losses to legal bettors on the games. The German Football Federation, long criticized for mismanagement, is under pressure to clean up its act before Germany hosts the 2006 World Cup. Now, politicians across the spectrum want stricter oversight—a move likely to be welcomed by both sponsors and fans.

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IGT: In Search of The Next Jackpot

The slot-machine biz has cooled, but foreign sales and a design push offer hope

FEW COMPANIES HAVE managed to stack the odds in their favor as successfully as International Game Technology. Over the past decade, as demand soared for new slot machines—in Indian casinos, riverboats, and splashy new Las Vegas resorts—IGT hit the jackpot. Of the 800,000 slot machines now in place at U.S. and Canadian casinos, about 70% were sold by the Reno (Nev.) company. IGT earned a record \$488 million on sales of \$2.5 billion in 2004—another year of the kind of double-digit growth that helped it secure the No. 18 spot on *BusinessWeek's* annual list of the 50 best-performing large companies.

But nobody's luck runs forever. Even America's gargantuan appetite for gambling has its limits. IGT's chairman and CEO, Thomas "T.J." Matthews, jolted investors on Jan. 20 when he announced that the company's domestic slot-machine shipments had fallen 35%, to 14,700 units, in its first quarter, ended

Dec. 31. Matthews said earnings for the rest of this year would probably be flat, at around \$1.35 per share. IGT's share price tumbled \$3.50, or 10%, in one day, as investors digested the challenges facing the company. A big industry conversion to coinless slot machines has largely run its course. Fewer states are opening their doors to casino gambling. And IGT's competitors are coming at the market with renewed vigor.

Matthews, 39, is determined to get IGT back in the money. A Las Vegas native with a keen interest in math, he helped develop the technology behind IGT's Wheel of Fortune slot machine. That machine, with its ability to connect to other devices to deliver multimillion-dollar jackpots, has been the most profitable one-armed bandit in history. IGT has long been an innovator: It was the first to market video-poker machines, in the 1970s. It was an early adopter of technology that in the 1980s replaced the old mechanical

ONE-ARMED BANDITS So 70% of the slots in North America are made by IGT

spinning reels with chips. More recently, IGT pushed to replace coin machines with ones that dispense paper receipts that can be used at other machines or deemed for cash. That cut casinos the cost of coins and increases the frequency of play.

A HIT IN JAPAN

TO GET BACK on track, Matthews says he'll focus on new types of games, international sales, and developing business beyond traditional slots. "We find that the real

value is in creation," Matthews says. "We're spending \$140 million this year on research and development. Our next big competitor is spending \$50 million."

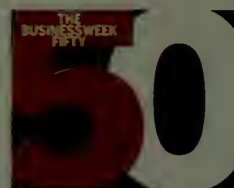
The industry is getting much more competitive, though. With some half a billion coinless slot machines now in place, industry slot sales are expected to fall this year, says Deutsche Bank Securities Inc. Regulatory approvals for slot machines in New York, Pennsylvania, and other states have come slower than expected. Today the big growth is in penny and nickel slots, which offer 20 or more chances to win on each spin. By playing more bets with lower denomination coins, gamblers win smaller but more frequent payouts. A recent winner lived WMS Industries and Australian up-and-comer Aristocrat Leisure Ltd. got a nearly start in this segment.

But IGT has kept its gamblers busy. At the Global Gaming Expo last September, it introduced more than 180 new games, of all types, nearly as many as in 2003.

IGT is making inroads overseas, with sales volume jumped 73% in the quarter on the strength of new Japanese games. But Matthews is also pushing casino-management software, such as a system to customize machines to a customer so that bonus rounds and other promotions pop up when a gambler inserts his frequent-player card.

Much like a frequent slot player, Matthews ran into a cold streak. Now, Matthews must prove to investors that his play is worth another tug of the handle. ■

—By Christopher Palmeri in Los Angeles



The Best Performers

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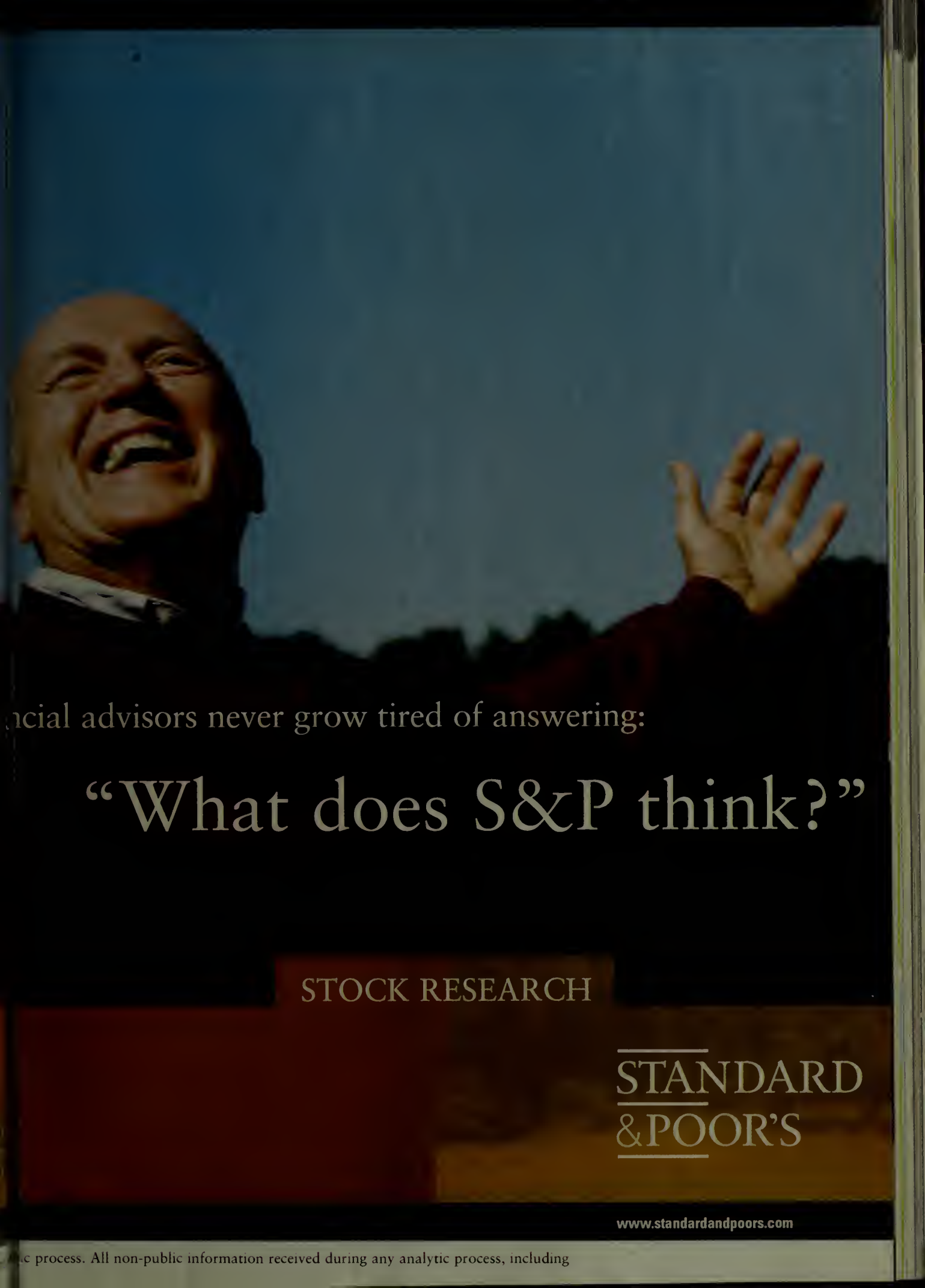
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A man with a joyful expression, laughing with his mouth open and eyes closed, has his right hand raised in the air. He is wearing a dark sweater over a collared shirt. The background is a clear, bright blue sky.

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COMMENTARY

BY RICHARD S. DUNHAM

Good Grief, They're At It Already

Why 2008 Presidential hopefuls Clinton, Kerry, and others are starting so soon

ONLY THREE MONTHS after the end of an exhausting, expensive, and seemingly endless campaign, an expanding group of Democratic heavyweights and relative unknowns is already testing the White House waters for 2008. If you think this is an extremely early start even for what seems to have become a perpetual pursuit of the

Presidency, you're absolutely right.

So what has gotten into those die-hard Dems? For one thing, former Vermont Governor Howard Dean's run at a hostile takeover of the Democratic National Committee has jolted some contenders out of their post-election torpor. First off the starting blocks: Senators Hillary Rodham Clinton and John Kerry. Clinton is charging out to shape her image before her enemies—or the media—do it for her. And much to everyone's surprise, 2004 nominee Kerry is acting more like battle-tested hero than washed-up loser.

In the early scramble, Clinton is hurrying to reintroduce herself as a common-sense, family-values centrist. On Jan. 24 she told family planning advocates in Albany that abortion was a "sad, even tragic, choice" and endorsed teen abstinence programs. While repeating that abortion should remain legal, she said Democrats should work to reduce the number performed. Since George W. Bush's 2004 victory, Clinton also has talked of the importance of faith in her life. And she has continued to remain hawkish on Iraq while backing anti-terrorism funding for projects ranging from port security to antimissile technology. But can she pull off an ideological facelift? "It's not easy to do when you have a long track record and product identity," says Raphael Sonenshein, a political scientist at California State University at Fullerton.

Still, should Clinton seek the nomination, she starts out as the prohibitive favorite. She'll have deep pockets, a cadre of en-

thusiastic supporters, and the Clinton political machine. Polls give her a double-digit lead over any possible foe. "Hillary's running, who's going to beat her?" asks Emory University political scientist Merle Black.

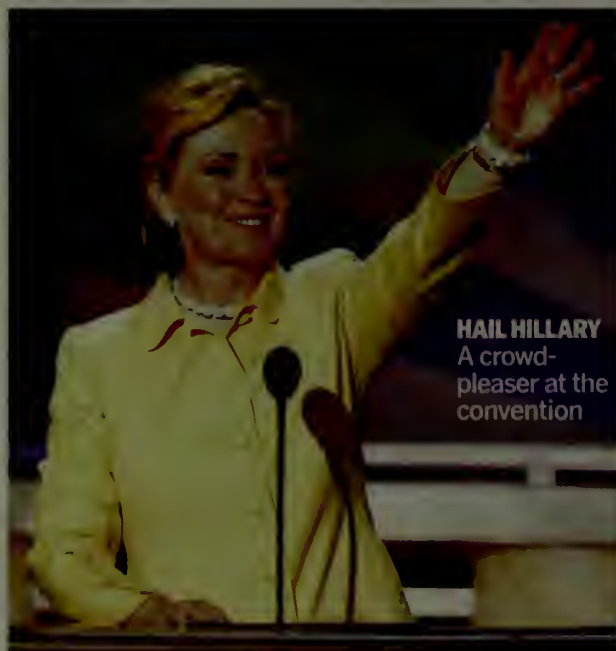
Well, Kerry seems to fancy himself the comeback kid. In January he stepped back into the public eye with forceful criticism of Secretary of State Condoleezza Rice, a high-profile speech on health care, and an appearance on *Meet the Press*. He says he hasn't ruled out another run in 2008, and he has nearly \$10 million in surplus funds and a list of 2.9 million names.

Kerry's former running mate, John Edwards, would face a bigger challenge taking on Clinton—especially since his performance as Vice-Presidential nominee has some party insiders wondering whether he is tough enough to slug it

with the heavyweights. Still, Edwards is quietly working the underdog circuit. He is scheduled to appear at a Feb. 5 fund-raising dinner for New Hampshire Governor John E. Sununu.

Many New Democrats who believe that the party will never reclaim the Presidency without appealing to the centrist swing voters are touting a moderate move. In a recent poll, Senator Evan Bayh. In a reverse-Clinton move, the decision to moderate Bayh reached out to liberals by casting 1 of just 13 votes against Rice's confirmation. And those who think a Washington outsider has the best chance are talking up a handful of "red state" governors, including Mark R. Warner of Virginia and Tom Vilsack of Iowa. Mindful that the last two Democratic Presidents were Southern governors, Sonenshein notes, "a governor from a small state is a better candidate than a senator from a large state." The trouble for all the would-be contenders is that they don't have the name recognition, fund-raising abilities, or national organization of Clinton or Kerry.

There's still plenty of time for a dark horse to steal the spotlight. But to succeed, it will take an early and hard run to catch the fast-out-the-gate favorites. ■



HAIL HILLARY
A crowd-pleaser at the convention

Clinton's new approach on abortion continues her shift to the center



moving forward ▶

*Mile 000174: The first time you see how
ugly a possum is.*

Mile 000174.1: You swerve anyway.

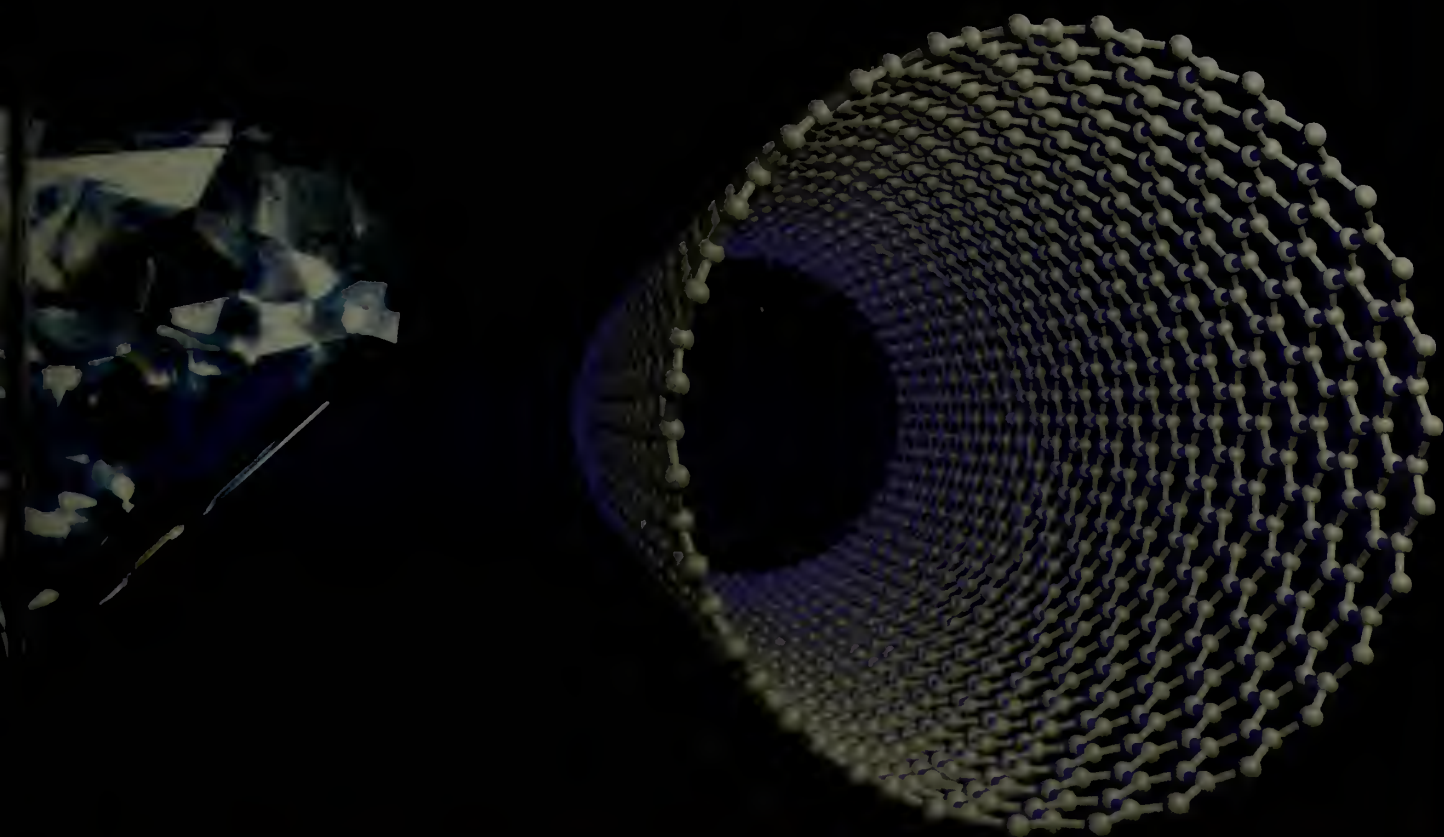


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COVER STORY

THE BUSINESS

THERE'S STILL PLENTY OF HYPE, BUT NANOTECHNOLOGY IS FINALLY MOVING FROM THE LAB TO THE MARKETPLACE. GET READY FOR CARS, CHIPS, AND GOLF BALLS MADE WITH NEW MATERIALS ENGINEERED DOWN TO THE LEVEL OF INDIVIDUAL ATOMS. **BY STEPHEN BAKER AND ADAM ASTON**



OF NANOTECH

Y THE POOR ALCHEMISTS. THEY SPENT THE Middle Ages in candle-lit laboratories, laboring to brew universal elixirs and to turn base metals into gold or silver. They failed utterly. By dawn of the Scientific Revolution, researchers equipped with microscopes founded modern chemistry—and dismissed alchemy as quackery.

But it turns out alchemists were just a few centuries ahead of schedule. Today, in sparkling labs equipped with powerful microscopes, scientists on three continents are promising dramatic new materials and medicines that would make alchemists proud. This work takes place in the realm of nanotechnology, industry's tiniest stage. The standard unit of measurement, a nanometer, is a billionth of a meter—barely the size of 10 hydrogen atoms in a row. In this universe entire molecules can unfold on the tip of a pin, and a single molecule packs the punch of a raging hurricane.

Why so small? Researchers have discovered that matter at this tiny scale often behaves very differently. While some of the science behind this phenomenon is still shrouded in mystery (page 68), the commercial potential of the infinitesimal is coming sharply into focus. Familiar materials—from gold to carbon soot—display startling and useful new properties. Some transmit light or electricity. Others become harder than diamonds or turn into potent chemical catalysts. What's more, researchers find that a tiny dose of nanoparticles can transform the chemistry and nature of far bigger things, creating everything

ABOVE: BUILDING BLOCKS OF THE NANO AGE Researchers are working on a variety of nanoscale materials, including carbon nanotubes, which are tiny tubes of carbon atoms that are stronger than steel and can conduct electricity. Other researchers are working on nanoscale materials that can be used in a variety of applications, including medicine, electronics, and energy.

from fortified fenders to superefficient fuel cells. Engineers working at the nano scale have a brand-new tool kit that's full of wonder and brimming with potential riches.

Now it's time to start cashing in. Throughout 2005, companies large and small will be rushing more nano-based products from labs to the marketplace. Consumers will encounter nanotechnology in the form of nick-proof trims on Hummers, Wilson tennis racquets with extra pop, even golf balls designed to fly straight. Investors, meanwhile, will be faced with a slew of bold announcements. On Feb. 1, for example, computer giant Hewlett-Packard Co. disclosed a breakthrough in nanotechnology that, within a decade, could carry computing beyond today's silicon and transistors. "We are reinventing the computer at the molecular scale," says Stan Williams, an HP senior fellow and co-author of the report.

For now, nano is starting out modestly. The biggest markets for nanoparticles remain in familiar products, from the black rubber filler in tires, a \$4 billion industry, to the silver used in traditional photography. Lux Research Inc., a New York nanotech market researcher, estimates that only \$13 billion worth of manufactured goods will incorporate nanotechnologies this year. That's little more than a rounding error in the global economy.

Feverish Activity

YET NEW NANO-BASED products that could have a far bigger impact are only a step or two away. Within the next two years, diagnostic machines with components built at the nano scale should allow doctors and nurses to carry pint-size laboratories in their briefcases, perhaps to test for HIV or count white blood cells on the spot. Nano sensors will scour airports and post offices for anthrax and sarin. Toward the end of the decade, scientists say, new computer memories composed of nanoparticles could conceivably pack the digital contents of the Library of Congress into a machine the size of a yo-yo. By that point, Lux predicts, nanotechnologies will have worked their way into a universe of products worth \$292 billion.

How does nanotechnology conjure up such surprises? Nature provides examples of this molecular magic. Think of coal compressing, over millennia, into diamonds. The gems are made of the same carbon atoms. But they've been rejiggered over time into orderly crystal patterns linked by superstrong chemical bonds. Soft becomes hard, sooty blackness becomes glittering clarity.

These days scientists can pull off such transformations between coffee breaks. With atomic probes they manipulate molecules, one-upping Mother Nature. Delving into the nano realm gives them startling surprises right in the old periodic table of elements—and they're filing a flurry of patents to lay claim to these miraculous materials. "It's a land grab," says Douglas Sharrott, a patent lawyer at Fitzpatrick, Cella, Harper & Scinto in New York.

NEW MATERIALS RENEWED PRODUCTS

Nanotech can help cars resist dents—and make medical tests speedier

TOUGH The truck bed of GM's Hummer H2 SUT is lined with rugged nanocomposites

THE NANO UNIVERSE EXPANDS ACROSS THE MATERIAL WORLD

Nanotechnology is taking its first steps into basic materials, from coatings to khakis. But over the next two decades it will spread into virtually every industry. A look at what's happening:

TOOLS

IMPACT New tools development are enablers. Without nano particles are tiny to see or engineer. Companies that see atomic-force microscopes and machines that manipulate molecules are early winners.

PLAYERS FEI, Nano

CHALLENGE

The market is up and running. Now it's crucial to keep innovating.

AVAILABLE NOW

The questions around nano are no longer whether it's real or if it's real but just how big it will be. Some see nanotechnology as a new material revolution, akin to the dawn of plastics. Others herald a transition as dramatic as mankind's advance from stone to metal tools. But those hazy predictions aside, the questions that are echoing from laboratories in Tokyo to the hectic offices of short-sellers on Wall Street are about now. Which nanotechnologies will create new fortunes, industries and corporate champs?

Activity on the ground is feverish. Some 1,200 nano startups have emerged around the world, half of them in the U.S. Companies that long labored in dull-as-dishwater materials businesses are finding that they can create a stir by trumpeting mastery over age-old particles, from specks of ceramic to polymers. Brokerages such as Merrill Lynch & Co. and Punk, Ziegler & Associates are scouring the markets for nano-focused companies, plunking them into nano indexes. Meanwhile, investors



ALS

inter tennis rackets
p. 100, paint that
fabric coatings
tain. You won't
ano—only that
ork better.

Dow Chemical,
NanoDynamics,
Materials, NASA.

Manufacturing
particles in
trial quantities is still
a stretch. Too much
hype followed by
a product fail-
ure could hurt.

NANO GOLF BALL

It'll straighten
out your drives.

ENERGY

IMPACT Low-cost nano-based films promise to capture more of the sun's light than today's photovoltaics and could spark a revolution in solar power. Carbon nanotubes show potential for use in super-electric batteries and hydrogen storage. This improves the odds that hydrogen fuel cells could replace fossil-fuel engines.

PLAYERS Carbon Nanotechnologies, mPhase Technologies, NanoSolar, Nanosys, UltraDots.

CHALLENGE Promising lab work will take time to scale up—and bring costs down.

HEALTH CARE

IMPACT Portable labs to provide instant analysis for everything from diabetes to HIV are in the works. Implantable health monitors—far smaller than pacemakers—could use nanomaterials to draw power from the body's heat. Ultraprecise nano agents may ultimately be able to kill cancer cells or bombard the blood vessels that nourish tumors.

PLAYERS BioPhan, GE, Johnson & Johnson, LabNow, Nanokinetics, NASA, Quantum Dot.

CHALLENGE Noninvasive diagnostic tools should come to market fairly soon—if companies can prove to regulators that nanomaterials injected into the body won't do harm.

NANOELECTRONICS

IMPACT By 2020 handhelds packed with nanowires could wield unimaginable power and terabytes of memory. Carbon nanotubes are top contenders to replace silicon-based chip technology, which could hit physical limits by 2015. Nanotubes can emit light, too, so they're being developed to replace bulbs and illuminate flat-panel displays.

PLAYERS HP, IBM, Intel, Nano-Proprietary, Nantero, NVE, Samsung, Zettacore.

CHALLENGE To scale up today's nanochip prototypes—made of just a few circuits—to the billions needed will require a leap in manufacturing technology.

THREE YEARS

NEXT FIVE YEARS

NEXT EIGHT YEARS

NEXT DECADE

been an alluring new market and the fear of a dot-com-like bubble, are struggling to get a grip on exactly what nano means for them.

Their confusion is understandable. Nano is not a single industry but a scale of engineering involving matter between 100 nanometers. Instead of one new phenomenon, like the Internet, nano offers new possibilities for thousands of materials that already exist. This means much of the early activity will take place at industrial giants. Already, 19 of the 30 companies in the Dow Jones industrial index have launched nanotechnology initiatives. Says Margaret Blohm, manager of General Electric's technology research and development program: "I lose sleep at night because expectations are so high."

How do these tiny molecules create big new products? Some of the size alone is the key. Consider DuPont's new Voltron, a durable wire coating used in heavy-duty electric motors. It looked at previous generations of such coatings through

a powerful microscope, the chemical components would look loosely packed, with irregular spaces between the molecules. This structure leads the material to break down more easily. Voltron's nanoscale particles fill in many of the voids, making a stronger insulator that lasts longer. In DuPont's tests on electric motors, a coating of Voltron extended the time between failures by a factor of 10, to more than 1,000 hours. And since such motors consume an estimated 65% of U.S. electric power, lengthening their life and efficiency promises big energy savings. "This chemical combination can only be done with nanomaterials," says Krish Doraiswamy, a senior planning manager for DuPont's nanotech research effort.

Most of the early advances in nano will improve what we already have. Examples: lightweight army fatigues that resist chemical weapons and food packaging designed to keep last month's lettuce green and crunchy. Later this year, duffers will be able to buy golf balls manufactured by NanoDynamics Inc.

in Buffalo, N.Y., that are designed to prevent a shift in weight as they spin. This should create balls that fly straight down the fairway and even hold a steadier line on the putting green. "If demand for the balls takes off, this could become a major business for us," says NanoDynamics CEO Keith Blakely, who plans to sell the balls for a pricey \$5 apiece.

Beyond straight putts and fresh produce, can nano live up to its potential to create entirely new industries and corporate titans? The answer de-



Nanoceramics to make GE's more efficient

QUICK STUDY A nanofilter from LabNow will give patients a fast count of white blood cells



depends on how the players, from regulators to entrepreneurs, handle a host of thorny challenges. Governments must devise smart regulations to control new materials and therapies. Companies face logistical conundrums, such as carrying out quality control on shipments of minuscule carbon nanotubes and silicon crystals—the I-beams and sheet glass of this industrial revolution—that are virtually invisible.

The nascent industry also must hammer out standards and enforcement practices that are sorely lacking. A 2004 study by Lux Research found that many of the 200 global suppliers of basic nanomaterials failed to deliver what they promised. “As a group they have a frighteningly poor track record,” says Lux Vice-President Matthew Nordon. The upshot? Until the industry puts a qualified supply chain in place, only innovators working with world-class labs can count on reliable material. This limits access to nanotechnology and hurts its growth.

An even greater challenge for nano industries is to ensure that their new materials are safe in the human body and in the environment. Setbacks could sink nano companies and even lead to a global backlash among the same activists who are raging against genetically modified food. “I’m worried about an overreaction to both the hype and the fear,” says Kristen Kulinowski, an executive director at Rice Universi-

ty’s Center for Biological & Environmental Nanotechnol-

Such concerns rattle the equity markets. As recently as last summer, about a dozen nanotech companies were positioning themselves for initial public offerings. But last year’s widely anticipated IPO in the sector—a \$115 million offering by Nanosys Inc. in August—was withdrawn at the last minute as investors cooled to a company rich in patents but still far from making a profit. Now the IPO market appears stalled for stars such as Nanofilm, a profitable Valley View (Ohio) manufacturer of optical films, and Konarka Technologies (Lowell, Mass.) leader in plastic solar panels.

Premature Marketing?

DOUBTS AND CONFUSION PLAGUE the market, where even the definition of nano is open to debate. When Merrill Lynch analysts released their Nano Index last April featuring 25 companies, critics howled that they were fueling hype—and that many of the pharmaceutical outfits on the list were included simply because they engaged in the common practice of making claims. Merrill retooled the list, limiting it to companies that explicitly stress a commitment to nano. Still, Manuel P. As-

WHY THE OLD RULES DON'T APPLY

At this size, familiar materials can do things they couldn't do before

How does nanotech work? For starters, it's tiny. For lots of jobs today, that's a prerequisite. The semiconductor industry needs ever-smaller tools and components to build coming generations of chips. Nothing bigger than nano-scale bits will fit. Similarly, some of the latest fuel cells carry nano-scale meshes on their filters. These help to sift electrons from hydrogen ions—a crucial step in creating electricity. For exacting work like that, *nano*—from the Greek for dwarf—is a perfect fit.

Nanotech derives much of its power from transformations that occur when matter is reduced to the molecular dimension. For

example, breaking down a chunk of a material into nanoparticles vastly increases its surface area, often by a factor of millions. This makes it dramatically more reactive—quicker to ignite or melt and absorbing more faster. Think of a spoonful of confectioner's sugar dissolving instantly in a cup of coffee, while a sugar cube in another cup has barely begun to lose its sharp corners.

Why does this matter? Drugmakers are betting that nano's greater absorption rate will lead to far more efficient dosages of drugs, many delivered as nano specks. And by making the particles chemically reactive, scientists are building exquisitely sensitive sensors that can detect individual molecules.

Thanks to all that surface area, nanoparticles often appear hypersensitive. Take gold. Although inert when wrapped around a finger or filling a tooth, at its tiniest size it becomes a potent catalyst—one that could be used to purge carbon monoxide from the atmosphere. And aluminum at the nano scale “can catalyze rocket fuel,” says Steve Jurvetson of Silicon Valley venture-capital firm Draper Fisher Jurvetson, which has invested some \$95 million in 11 nano startups. “It literally explodes.”

Lots of other changes occur when matter sheds its heft. Some nano materials, when reduced to a size smaller than a wavelength of light, become invisible. This opens the possibility of having materials we know as opaque, such as silicon, transmit light. Others become fabulously strong. Carbon nanotubes, for example, share a similar atomic structure with their cousin, the diamond. This makes them sturdy, yet the willowy form leaves them as flexible as a noodle—a combination of strength and suppleness that's tough to find in the larger universe.

Lots of the nano world remains a mystery. In its miniature form, matter pays little heed to the familiar world of Newtonian physics. The laws of gravity, optics, and acceleration represent averages, not the quirky behavior of each single nanoparticle. For those principles, researchers must venture into quantum physics. Those who come to grips with this realm and can harness its power stand to become the titans of the nano age.

—By Stephen Baker and Adam Aston in New York

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Where 2.7-billion phone connections get routed.
Where 3,000 global enterprises get secured.
Where \$100-million in online commerce gets transacted.
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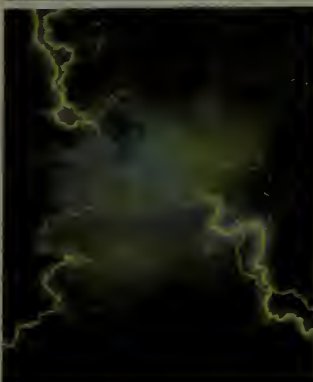
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NANOTECHNOLOGY STEP BY STEP

The carbon nanotube, first discovered by NEC in Japan in 1991, is one of the most versatile and promising nanomaterials. Here's a nanotube's voyage from lab to market.



CREATE

1 Scientists direct a bolt of electricity—or an intense flash of laser light—into a high-pressure chamber of gas rich in carbon molecules. This sparks the formation of cylinders of carbon atoms, or nanotubes. While nearly invisible, these threads are 10 times stronger than steel and extremely heat-resistant.



ENGINEER

2 Using chemicals and beams of energy, scientists have learned how to sort out and manipulate different classes of nanotubes. Some types conduct electricity, others are especially strong. Scientists are weaving them into fortified string and fabrics.



EXPERIMENT

3 Researchers have been incorporating nanotubes into basic materials, from textiles and plastics to wiring on miniature electronic circuitry. Teaming with biologists, they're attaching the hollow tubes to organic molecules and testing them for medical therapies.



APPLY

4 Nanotubes show promise in a vast array of products, starting with today's superstrong fabrics. In time nanotubes may replace the transistors on ultrafast computer chips, light up the pixels in new TVs, and give birth to shape-morphing plane wings.

president of Asensio & Co., a short-seller that is still b against the stock of one nano index company—NVE C maker of electronic sensor instruments—continues to gr “There is no market yet,” he says. “Isn’t Merrill attempt create a retail fervor?” Merrill’s Steven Milunovich, who c its nanotech research, responds that the firm covers only t the stocks on the index and compiles the list not to recom investment vehicles but as a way to track the young inc “It’s a 30-year trend, and we’re only at the beginning,” he

In today’s cautious climate, investors are focusing le dazzling visions and more on companies with real pro customers, and profits. The leading performer in Merrill’s in 2004 was MTS Systems Corp., a 39-year-old testing-c ment company whose tools are widely used in nano lab stock rose 80%. Harris & Harris Group Inc., a venture-c firm with heavy investments in nano, saw its stock rise 75 sign that investors hold high hopes for the segment. But businesses selling true nano products, from materials con Altair Nanotechnologies Inc. to France’s Flamel Technol a medical supplier, suffered market declines through 2004 the Merrill index fell another 12% in January, 2005.

No doubt nano is in for its share of bumps, with flops s outnumber successes by a wide margin. Yet the technol the tiny is on track to disrupt nearly everything in its pat cluding companies, industries, and universities. Why? A atomic level the boundaries among biology, chemistry, ph and electronics lose much of their meaning. The sciences to merge. Many of the winners in nano will be those tha reach across old boundaries and create novel hybrids. Isra ologists and electrical engineers, for example, have team to attach dna to carbon nanotubes to create microscopic sistors. These assemble themselves in the lab following a logical blueprint. The result is an inanimate transistor—but that grows, like a tadpole or a toenail.

Funding Magnet

COMPANIES THAT CAN BRING such innovations to m stand to restructure entire industries. Korea’s Samsung G plans to produce TV displays featuring the most prom building blocks of the Nano Age—carbon nanotubes—by 2 If successful, these screens could be lighter, cheaper, brig and more energy-efficient than today’s models. The techn would spread quickly from TVs to computer screens, even tronic billboards. GE is adding a new nano-focused wing R&D center in Niskayuna, N.Y. The company won’t disclos size of its investment but says a 50-member team of resear is looking to seed nano into everything from medical techi gy to lighting to high-performance turbines.

For entrepreneurs, nano spells funding. Venture capit have invested \$1 billion in nano companies, nearly half of the past two years. Meanwhile, government funding is hol steady at \$4.7 billion annually, nearly equally divided an Asia, Europe, and North America. The cash is pouring into versity labs and new nano corridors from Albany to Shan and Fukuoka prefecture in Japan. “Any professor with his screwed on has moved research programs into nano,” Greg Blonder, a partner at Morgenthaler Ventures.

Many of the early prospectors are focusing on health- testing tools, which are far less regulated than medicines therapies. LabNow Inc., an Austin (Tex.) startup, has its s set on addressing the AIDS epidemic. Using minute char and sensors, the company has devised a blood laboratory

Data: Rice University BW

he size of a business card. The patient places a single drop of blood on the chip, which is then inserted into a small electronic reader. Within minutes, HIV/AIDS patients can get a reading of their white blood cells—a crucial metric for treatment. Currently that test takes weeks or months in poor regions of the world, where blood samples are trundled back and forth in slow trucks. Patients can die waiting for the results. LabNow's technology has the potential to speed up treatment in much of the world—and let LabNow tap into the \$5 billion global market for point-of-care diagnostics. In October, LabNow got \$14 million in equity financing from a consortium led by George Soros. The company hopes to roll out its systems in South Africa by the end of 2005.

Red Flag

DRAMATIC BREAKTHROUGHS are expected within two or three years as companies developing novel medical procedures begin to emerge from the regulatory maze. Already, nano-sized versions of existing drugs are causing a stir. Last month, American Pharmaceutical Partners Inc. shares surged 50% on news that the Food and Drug Administration had approved the marketing of Abraxane, a nanoscale protein-based drug for the treatment of metastatic breast cancer. The nano-version is able to squeeze into places in the body that its existing macro counterpart cannot reach without intolerable side effects. Further out, researchers are working on customized treatments, such as nanoparticles built to match the unique genetic profile of a patient's cancer cells—and programmed to seek out and destroy them. Hundreds of these therapies are in the works. Many will fail. But if even a handful succeed, they could change medicine.

To achieve such triumphs, nano companies must squelch fears about the effects of the particles in the body. Worries grew last spring when researchers at Northern Methodist University reported brain damage in a 10-month bass that had been swimming in an aquarium filled with common carbon-based nanoparticles known as fullerenes. Although far from conclusive, such findings raise red flags worldwide—and they extend far beyond the netted legions of activists. Last year, giant reinsurer Swiss Reinsurance Co. warned against a rush into nano, citing “the unseeable nature of the risks it entails and the recurrent cumulative losses it could lead to.”

NANO RISKS

cash in on nanotechnology, companies must overcome a slew of challenges. Here are three biggest:

HYPE

Think Internet bubble 2.0. Extravagant hopes could fuel a global surge of investment followed by a backlash when products stumble in the market, are nixed by regulators, or fail to impress. This could slow development of nanotech by years.

TOXICITY

The air and water around us are awash in harmless, naturally occurring nanoparticles. But if any of the new engineered nanoparticles are found to wreak havoc in the body, the entire field could face the same fervent global opposition that has hobbled genetically modified food.

TIMING

Miracles often arrive late. Consider genomics. A decade ago it promised scads of drugs and medical therapies that are still pending. Market turmoil, public fears, or production screwups could cause delays in nano, holding up breakthroughs in energy and medicine for a decade or more.



LOTS OF POP

Nano-size silicon dioxide crystals help power this Wilson nSixOne tennis racket

Nanometer Scale Science & Technology labs.

Despite this progress, it's a long hike to nanocomputing, not a sprint. HP researchers don't expect their platinum circuits to debut until 2011 at the earliest. And it won't be until much later in the next decade, say scientists, that nanotechnology may be able to provide a new architecture for faster computing in the post-Silicon era.

The future of nanotechnology? It may seem strange now, but within a decade or so the term is likely to vanish from syllabuses and portfolios and remain part of company names only as a vestige of the past. After all, nano denotes only size. Once work on that scale becomes routine, that buzzword will fade. But the physical world—medicines, metals, and even the roles the elements play—will be utterly changed by this revolution, all brought about by bits far too small for the eye to see. ■

BusinessWeek online For additional articles, on the impact of nano on a startup and a university, go to www.businessweek.com/extras

Citi: A Whole New Playbook

Chuck Prince is moving away from Sandy Weill's empire-building strategy

TWO MONTHS AFTER Charles "Chuck" Prince was named chief executive of Citigroup in July, 2003, investment bankers came calling. Would Prince be interested in selling one of the last vestiges of Travelers Group, the business merged with Citicorp in 1998 to form Citigroup in a \$72 billion deal—at the time the largest merger in U.S. history?

The answer, predictably, was no. Prince wasn't due to move into the CEO suite until December and was not about to start dismantling the empire that took his longtime patron and boss, Sanford I. "Sandy" Weill, 18 years to build. Under Weill, Citigroup and its predecessors were voracious acquirers, and Prince was along for the whole ride. "I remember very fondly the days when, every two or three years, we would change the name of the company—Commercial Credit, Primerica, Travelers," Prince told *BusinessWeek*. "That was the force that got us here. But the days of doing big consolidating transactions that completely transformed the company are behind us."

Now Prince is stamping his own forceful imprint on the nation's

largest bank. This time around, it was Prince calling the investment bankers—to sell Citigroup's Travelers Life & Annuity unit and all of Citigroup's international insurance businesses, except the Mexican unit—for \$11.5 billion to insurance giant MetLife Inc. on Jan. 31. In Prince's view, those businesses sucked up the bank's valuable capital and exposed it to interest-rate risk and big earnings swings. By shedding them, he freed up \$6 billion of capital and made a \$2 billion gain on the sale.

What's more, he took a large step in moving Citigroup away from its original goal of becoming a one-stop financial shop that produces all its own insurance and banking services. In a similar move, American Express Co. announced on Feb. 1 that it would spin off its brokerage and money-management unit to shareholders later in the year to focus on its card and payments business. The initial hope of many financial companies that welding brokerage, insurance, and retail banking businesses would create sales synergies just didn't pan out. "The trend now is toward specialization," says Jeffrey Schuman, an analyst with investment bank Keefe, Bruyette & Woods Inc.

At Citi, nothing now remains of the Traveler's



Travelers' HQ

Insurance just "doesn't produce the returns for the risk," one analyst says

deal but the ubiquitous red umbrella badge of integrity that Weill coveted built his financial-services power from scratch. Prince is no less ambitious but his playbook is entirely different. The 55-year-old former general counsel wants to redirect capital to higher-growth and higher-return businesses, streamlining the bank and be "the most respected company in the world." He aims to build on Citigroup's scale with small, targeted investments that play to its strengths while shedding businesses that have become liabilities. And he acts decisively when the bank's credibility is at stake. On Oct. 1, he fired three top executives blamed for the regulatory failures that got Citigroup out of private banking in Japan (page 72). "These are conscious, strategic decisions," says Prince.

BACK TO BASICS

CITI IS NOT the first to reverse its strategy on the insurance business after proving it as a cross-selling miracle. General Electric Co. sold its life and mortgage insurance unit—Genworth Financial Inc.—in a \$2.83 billion initial public offering last May. (Under Weill, Citigroup had already spun off its Travelers Proper



His Own Man

Citigroup CEO **Chuck Prince** is quickly reshaping the financial behemoth built by his predecessor, Sandy Weill. His blueprint:

DUMP underperformers such as Travelers' life and annuity business and CitiCapital's equipment-leasing business, focusing on core banking activities and moving away from the financial supermarket model.

REDEPLOY capital abroad. Last year Citi bought South Korea's KorAm Bank and added 200 branches in Asia, hired 5,000 salespeople, and installed 1,000 ATMs in Asia. Expansion plans are in the works for Japan, Russia, India, and Europe this year.

STEER CLEAR of megamergers by passing on pricey deals such as buying Washington Mutual, SouthTrust, Deutsche Bank, or Abbey National.

TARGET smaller acquisitions that fill needs, such as Citi's purchase of Knight Trading's derivatives activities to tap into a hot growth market, and ABN Amro's securities-clearing business to bolster back-office operations.

Data: BusinessWeek

Corp. insurance business in an initial public offering in 2001.) "This life and annuity business just doesn't produce the returns for the risk," says David Anthony, insurance analyst with Argus Research. "So the solution is to give it to someone who does the business full-time." MetLife's acquisition of Citi's life and annuity business, in fact, makes it the largest individual life insurer in the U.S. Selling Citi's remaining stake in the unit also reflects Prince's larger vision to get back to basics. On his watch, Citi dumped CitiCapital's equipment-leasing business and sold its Electronic Services unit, which in part provided benefits payments and prepaid services for government employees. Citi also sold its 20% stake in the Saudi Samba Financial Group for about \$760 million and reduced its stake in Japan's Nikko Cordial Bank to 12% from 21%.

That's Prince going to do with the \$8 billion he sprung loose in the Travelers unit. In a Jan. 31 conference with analysts, he said he might buy back shares or use the dividend. Most analysts figure he'll also be in the market for niche acquisitions. He's always on the lookout for well-run banks in growing markets

such as Texas and Florida. And though he might buy a large bank if the price were right, don't expect the sort of megadeal that reprises the Weill days any time soon. "The deals would now have to be so large that there would be excessive execution risk," Prince told *BusinessWeek*.

POWERFUL ENGINE

INSTEAD, PRINCE IS focused on smaller acquisitions that fill specific needs. In the past 12 months, he has purchased Knight Trading Group's derivatives activities (to tap into a hot growth market) and ABN Amro's securities-clearing business to bolster Citi's back-office services. Citi also paid \$1.25 billion for Washington Mutual Finance Corp., a unit that provides consumer and secured real estate loans, among other products. Says Glenn Schorr, a financial-services analyst with UBS: "They're doing bolt-on transactions that make more sense, add to earnings, and won't change their stripes."

Prince will also continue to plow money into consumer banking all over the world. It's the main engine of Citi's growth, generating more than 60% of its profits. And while Prince opened 70 consumer-finance offices and 14 retail bank

branches in the U.S. last year, his real focus is in faster-growing international markets. Citi's consumer bank added 8.6 million new retail bank accounts in 2004, almost all of them international. At the same time it opened 203 international branches, increasing the number to 3,253. And its overseas credit-card business added 5 million new card accounts, vs. flat growth in the U.S.

The sales machine is running at full bore in other parts of Prince's Citi. New-money flows to its Smith Barney brokerage in the fourth quarter were the strongest in 11 quarters, at \$10 billion, and private bank assets under management increased 24%. Also, in the fourth quarter the company achieved a No. 1 global rank in underwriting investment-grade and high-yield debt as well as equities, according to Thomson Financial.

Despite Prince's best efforts, Citigroup's stock has hovered below \$50 for a year. His tenure has been marked by one public-relations disaster after another, with regulatory scandals erupting in Britain and Japan. Prince is also grappling with a \$48 billion annual expense base that needs serious paring. Expenses, in fact, exceeded revenues in seven of

Citi's nine units. Sallie L. Krawcheck, Citi's chief financial officer, says that's due in part to the cost of upgrading technology in the investment bank, opening retail branches, and training Smith Barney brokers. It's also based on sky-high legal expenses from run-ins with regulators and investors, which the bank is "managing aggressively," she says.

Indeed, regulatory misfires have had a huge impact on the bottom line. The bank

reported record profits for the past two years, but in 2004 net income fell 5% to \$17 billion because of the \$4.95 billion after-tax charge Prince took for settling charges over WorldCom and legal reserves related to Enron. In both cases, regulators alleged that the bank misled investors with inaccurate research.

Binge-and-purge transactions at large companies are often a byproduct of a dynamic market. "It's too easy to say that

Sandy built it up and Chuck [Schorr] took it down," says UBS's Schorr. "This is a company that's adapting to a changing environment. If Sandy were running the ship, he'd be doing the same thing. Maybe so. The iconic red umbrella [logo] is all that's left of the dealmaking empire that created the Citi empire. But Prince is determined to capitalize on its powerful brand as strong as ever. ■

—By Mara Der Hovanesian in New York

INVESTIGATIONS

Scrambling to Save Face in Japan

Douglas Peterson was attending a business dinner at a Tokyo restaurant early last September when he received an urgent call on his mobile phone—one he had been expecting since being appointed head of Citigroup's Japan operations three months earlier. Unable to extract himself from the dinner, he met the caller, a Citi staff member, in the bar. The news was grim: Japan's Financial Services Agency, which had been investigating alleged improprieties at the bank for months, had come to a decision. It would terminate Citigroup's private banking operations in the country.

Two weeks later the formal decision was handed down to close the private bank, a bitter pill that Citigroup recently disclosed cost it \$244 million in the fourth quarter alone. Peterson, who is CEO Chuck Prince's hand-picked troubleshooter in Japan, has been scrambling ever since to pick up the pieces. Job No. 1 has been bowing and scraping to FSA officials and other regulators, trying to convince them the bank is contrite and determined to make amends. At the same time, Peterson has been trying to bolster the consumer and corporate banking units, some of Citigroup's best franchises outside the U.S. "The Citibank brand in Japan is strong, and we want to recapture that," says Peterson, 45, who previously served as chief global auditor. "We know it has been damaged."

A key part of Peterson's mission is to make sure the damage goes no further. Citi officials blame unclear lines of authority for the problems in Japan, where the heads of key divisions reported to different bosses in



TOKYO Retail banking remains strong

New York. FSA investigators fault a culture where profits were chased at any cost. Bank officials allegedly misled some clients about their investments and gave loans to others that were used to manipulate stocks.

The lesson Citi learned from the private bank scandal was the importance of appointing country CEOs like Peterson, to whom all the Japanese staff now report. Another issue is recharging the remaining businesses. The private bank, which will close next September, was one of Citi Japan's smallest units, with 5,000-plus clients and only \$84 million in income. Citi's consumer, corporate, and brokerage arms

are far larger. Japan operations earned \$100 million in 2004, or 4% of Citigroup's total. Citi introduced the country to 24-hour ATMs and phone banking, and Peterson now wants to take advantage of a changing market. In December, the government lifted a ban on sales of securities at bank outlets. Citigroup has ties with Japan's third-largest broker, Nikko Cordial Corp., and is well-poised to offer brokerage services to its retail banking clients, although no decision has been made to do that.

A bigger challenge is consumer finance, the business of extending unsecured loans at double-digit interest rates. Citi has been a player in Japanese consumer finance since 2000, when it took over a trio of brands with 1,000 consumer loan outlets nationwide. Profit growth at the consumer finance unit has stalled because of an unexpected surge in defaults. Last year, consumer finance revenue in Japan slipped 7%, to \$2.5 billion.

Peterson now wants to appeal to more creditworthy clients. Two new programs were rolled out last month. The "Smart Lady" loan targets women by promising borrowers they will only deal with other women, a shrewd psychological touch. And a "Smart Loan" program aimed at 20- to 30-year-old clients guarantees 60-second approvals for a loan via a PC or Internet-linked mobile phone. While it's too soon to know if these will catch on, there are encouraging signs. The charges related to the scandal have put the Japan operation a whole in the red in the most recent quarter. But on Jan. 20, Citigroup reported that earnings from Japanese retail banking and consumer finance surged 54% in the last quarter, to \$163 million.

Sounds promising—as long as that scandal goes away. At least Citi appears to have convinced Japanese authorities of its sincerity. "Peterson recognizes the gravity of the problems," says Takafumi Sato, head of the FSA's supervisory bureau. Faint praise, but the best Peterson and his bosses can expect under the circumstances.

—By Chester Dawson in Tokyo, with Mara Der Hovanesian in New York

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CRITIC Atkins has strong concerns about "regulatory overreach."

Dr. No Digs In At the SEC

Commissioner—and fierce libertarian—Paul Atkins is slowing some key reforms

WHEN THE SECURITIES & Exchange Commission voted behind closed doors late last year to fine Goldman Sachs Group Inc. \$40 million for allegedly trying to pump up the prices of initial public stock offerings, there was one holdout. Commissioner Paul S. Atkins argued that the penalty was "too high," according to people with knowledge of the session. But Atkins didn't win over

fellow commissioners, who ultimately approved the fine. Atkins declined to discuss the settlement, which Goldman accepted without admitting or denying wrongdoing.

It wasn't the first time that Atkins was out of step. A firm believer in limited government, Atkins has harshly criticized SEC Chairman William H. Donaldson's drives to regulate hedge funds, force mutual fund boards to have independent chairmen, and promise investors that the best prices will be protected when they buy or sell stock. Behind the scenes,

Atkins increasingly balks at the fines that the five-member committee doles out to corporate wrongdoers and wayward executives.

So far he has managed only to slow some elements of Donaldson's agenda. His opposition is likely to get stronger. Pre-George W. Bush's reelection and the Republicans' gains on Capitol Hill give the GOP commissioner—whose term expires in 2008—more running room to challenge fines and an overhaul of stock-trading rules, a Donaldson priority.

CONSERVATIVES' HERO

TURNOVER AT THE SEC also could ouster Atkins. Harvey J. Goldschmid, a Democrat and strong Donaldson ally, plans to step down this year. And it's unclear whether Democrat Roel C. Campos will be reappointed this summer. Bush could replace either of them with a Republican, but business-minded Democrats could tip the balance in Atkins' favor.

Atkins' public broadsides against "regulatory overreach" have made him a hero in business and conservative circles. Some SEC-watchers think he's a growth thorn in Donaldson's side. His open challenges to the SEC chief's initiatives have fragmented the agency's voice and cast doubts about its commitment to position reform. Facing opposition from Atkins and Cynthia A. Glassman, the other Republican, Donaldson has relied on the two Democrats to push controversial proposals through on 3 to 2 votes.

Donaldson, who is expected to remain at the SEC at least through the end of 2005, declined repeated requests to comment for this story. A staff tally shows that of 2,361 commission votes during Donaldson's tenure through 2004, all but one or just 1.5%, were unanimous. But the agency that prides itself on nonpartisan consensus, dissents are rare—and 90% of votes on the chairman's priorities are still. Atkins' strong concerns have contributed to the stalemate on Donaldson's plan to help shareholders nominate directors to corporate boards.

Atkins makes no apologies. A libertarian, he believes the SEC should set disclosure standards, establish clear rules to protect investors, and nail fraudsters. He steers clear of dictating business practices that are better left to markets. "Market forces have great power to discipline people," Atkins told *BusinessWeek*. "We should try to second-guess them."

Raised in Florida, the soft-spoken lawyer is, at 46, the youngest commissioner. Before Bush appointed him in 2002, he ran a PricewaterhouseCoopers

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unit that did internal compliance investigations and consulting for financial firms. An engaging conversationalist fluent in French and German, Atkins practiced law in Davis Polk & Wardwell's Paris office for two and a half years in the 1980s and still travels widely. He lives in Virginia, where his wife home-schools their three sons. "Even though we're at the opposite ends of the policy spectrum, he's who I'd want to be seated next to at a dinner party," says Cynthia M. Fornelli, a former top SEC official who helped write the mutual fund and hedge fund rules.

Despite his easygoing manner, Atkins sparks palpable tension at the SEC. Glassman, a former Federal Reserve Board economist, also questions the SEC's rush to regulate. But insiders view her as a straight shooter who raises her concerns about proposals well in advance. Atkins, by contrast, tends to cloak his objections until the last minute, gumming up policymaking or blindsiding the agency in public, insiders say. Staffers were surprised at a meeting last February, when Atkins likened a plan to modernize stock-trading to the much-ridiculed 1975 Gremlin car. Atkins ultimately voted to publish the proposal, but his comments

Butting Heads

Commissioner Atkins puts up a fight as SEC Chairman Donaldson pushes new regulations and tougher enforcement

MUTUAL-FUND GOVERNANCE Opposed requiring mutual funds to have independent chairmen.

HEDGE FUNDS Voted against forcing hedge funds to register with the SEC.

TRADING Favors scrapping requirement for brokers to funnel orders to the market offering the best price for stocks.

CORPORATE GOVERNANCE Resists making it easier for shareholders to nominate candidates to corporate boards.

ENFORCEMENT Thinks SEC is too quick to impose stiff fines. Opposed penalties the commission levied against Wachovia, Qwest, and Goldman Sachs.

Data: BusinessWeek



Donaldson

had staffers stewing. "We didn't see it coming," recalls one. Atkins says that any misunderstanding was unintentional. "I try to communicate as much as possible."

Atkins' attacks raise eyebrows at the staid SEC. Last year he accused the agency of making "a tortured end run" around the law in order to regulate hedge funds. He

shook up another meeting by trotting out a made-for-TV chart to dispute Donaldson's contention that registering hedge-fund advisers would have deterred many firms.

What most incenses Atkins, though, are rumors that he badmouthed the agency and Donaldson to White House officials and has encouraged outsiders

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SEC policies. The U.S. Chamber of Commerce quoted from Atkins' and Glass-Steagall dissent when it filed a lawsuit in November challenging the rule requiring independent fund chairmen to be independent. It appears as if he is trying to undermine the "C" and position himself as Donaldson's successor, says one SEC-watcher. Atkins flatly denies the accusations and hasn't discussed the lawsuit with anyone at the Chamber. "The chairman owes me loyalty," he says. "I'm not out to the ladder." Many observers think the White House would be wary of such a controversial choice.

WH QUESTIONS

ATKINS ALSO IS digging in against Donaldson's push to exact hefty payouts from corporate wrongdoers. Several sources say he opposed the \$250 million penalty levied on Qwest Communications International Inc. for accounting abuses and a \$37 million fine for Wachovia Corp. for failing to fully disclose its purchase of Union Corp. shares during their 2001 merger. He has backed other big fines, including the \$750 million penalty on WorldCom Inc. paid. While he won't discuss specific cases, Atkins argues that

corporate penalties in many financial fraud cases hurt shareholders, who already have seen their stocks battered. "We ought to hold individuals accountable, not shareholders," he says. Proponents counter that penalties help to deter illicit behavior. "Executives do not want to be responsible for corporate penalties on their watch," says Commissioner Campos. "And to sting, a penalty in certain circumstances must be high."

Atkins' admirers applaud his outspoken dissents. "There's no reason for commissioners to fall into line" with the chairman, says Peter J. Wallison, a resident fellow at the American Enterprise Institute, a conservative think tank. If Atkins ruffles feathers, so be it, says Wayne A. Abernathy, a former top Treasury official. "What he does is ask the tough questions," says Abernathy.

His outspokenness is in marked contrast to Atkins' smooth SEC stint in 1990-94, when he worked for two activist chairmen. As executive assistant to Richard C. Breeden, a Republican, he helped evalu-

Some say Atkins is positioning himself as Donaldson's successor

ate enforcement cases and revamp proxy rules. "He is an extremely thoughtful person who did a wonderful job," recalls Breeden. Atkins stayed on as counsel to Breeden's successor, Democrat Arthur Levitt Jr., helping to develop town hall meetings for investors. (As a commissioner, he is passionate about investor education and has headlined

several of his own meetings.)

Now, though, Atkins has a platform and a favorable political climate to push his views. "The election seems to have emboldened him," says one top SEC official. Many shareholder advocates and Wall Street watchdogs fear that the SEC's post-Enron activism has already peaked. With changes in the commission and growing resistance from Corporate America, Atkins may not be on the losing end of SEC votes for long. ■

—By Amy Borrus in Washington

BusinessWeek online For a Q&A with SEC Commissioner Paul S. Atkins, go to www.businessweek.com/extras



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FOR A PROUD TECH INDUSTRY leader, the situation couldn't have gotten much worse than what IBM faced in the summer of 2003. The company's semiconductor unit, which had bet on a strategy of manufacturing all kinds of chips for all comers, had lost \$1.2 billion over the previous 18 months. Big Blue was also spending billions to upgrade its chip plants—and getting thrashed by Asian rivals that were manufacturing at much higher volumes and offering bargain-basement prices. It was a full-blown crisis. "We were in danger of being marginalized," recalls William M. Zeitler, senior vice-president in charge of the systems and technology group.

That called for a meeting of some of IBM's best minds. So on July 15, 2003, starting at 7 a.m., Chief Executive Samuel

J. Palmisano, Zeitler, and about 70 others from the company's then-separate chip and computer divisions gathered in a conference room at Harvard University to come to grips with the situation. By the end of a long day, they had charted a new course. The chip and computer units would be combined. Rather than manufacturing all kinds of chips for 400 customers, IBM would focus primarily on one family of chips, its well-regarded Power microprocessors. It would make some of the chips for its own use and others for key partners' products, including Nintendo game consoles, Apple G5 computers, and Cisco Systems networking gear. It would also recruit co-investors to help fund advances in chip manufacturing technology.

That high-stakes strategy shift is starting to pay off. Advances in Power chips have not only helped IBM gain share in high-end servers, they also have landed

Big Blue the coveted role as processor supplier for next-generation game consoles to Sony, Microsoft, and Nintendo. That's 100% market share. IBM has especially high hopes for the Cell chip, the brains of Sony Corp.'s PlayStation 3 console, which is based in part on IBM's Power technology and is being co-developed by Sony, IBM, and Toshiba. The pair are poised to reveal details at a technology conference on Feb. 7. One thing's to come: Cell will include a lot of Power processors, making it 10 times more powerful than today's consoles. If the momentum continues, IBM will emerge as a much more potent force in the processor realm.

TRICKY BUSINESS

THERE'S A STRATEGIC reason for IBM's Power Everywhere approach: It makes all the difference in the chip business. Right now, IBM has just 5% of the total 365-million-unit processor market, according to Gartner Inc., vs. about 40% for mighty Intel Corp. By concentrating on one family of chips and boosting its share of the processor market, IBM can make larger batches and do it more efficiently. The goal: to generate enough volume so it can invest heavily and stay on the cutting edge. "We want the Power architecture to be the foundation of the performing, most affordable, and flexible computing systems," says Zeitler.

IBM will have to overcome some challenges to accomplish that. Making a chip 1/1000th the width of a human hair is a tricky business, and one misstep could leave IBM behind. It ran into problems last year while switching to the

Big Blue Everywhere

IBM's Power microprocessors are used in a wide range of devices—from computers to cars to cell phones. Here are some key ones:



SPEED DEMON IBM's Blue Gene broke supercomputing records last year



SUPERCOMPUTERS

Thanks to Power, IBM holds the world record for supercomputing processing speed. An IBM supercomputer used in simulations has helped GM reduce the number of crash tests by 85%.

manufacturing methods for Apple Computer's processors, earning the company a public rebuke from Apple. The firm took more than six months to fix. A spokesman for Intel said IBM has not yet said it can produce processors efficiently in high volume.

IBM's other major challenge is the momentum of Intel and Advanced Micro Devices Inc. The pair's low-powered processors began being used in servers a decade ago, and then they've gained large chunks of the market. In 2004, for the first time, the number of servers that run on Intel and AMD chips exceeded those of the Unix servers, which included computers that run Power chips. So far, IBM Power has been gaining share within the Unix server market, but its market share has been shrinking. IBM needs to halt Intel and AMD's advance or face a loss of market share in the server market.

IBM dropped its own high-end processor design in favor of Intel's, expects its market share will be able to match IBM's in performance and beat them on price. "Any advantage IBM could have over us by designing its own chips is negligible," says John Hudson, HP's marketing vice-president for enterprise servers. If HP is able to live up to that claim, IBM will be in serious trouble.

IBM is based on the gains IBM has achieved in

the past couple of years, though, it has a solid chance of success. Its chip business turned profitable last year, although IBM no longer breaks out specific revenues and income for that segment. That, coupled with its strategy of finding co-investors for its chip-making capabilities, is helping it

stay on the leading-edge of chip manufacturing. On Jan. 5 the company announced a \$1.9 billion extension to its newest chip plant, along with partners Sony, Toshiba Corp., and others. And Big Blue's success in high-end servers and the fast-growing game market has experts convinced its Power processor is headed for steep growth. Analyst Tony Massimini of Semico Research Corp. figures IBM could easily be stamping out 70 million Power processors a year by 2007, up from about 15 million last year.

Up until now, most of Power's gains have come in the high-end server world.

Improvements in its server processors helped boost its market share in Unix servers from 15.2% in the third quarter of 2000 to 26.6% in the same quarter of 2004, even while the overall Unix market declined 46%. That puts IBM within striking distance of HP and Sun Microsystems Inc., with 32% and 29%, respectively, according to market researcher IDC. With the introduction of the Power5 chip last year, an IBM server ran a

standard data-processing job nearly three times faster than the previous record, says the nonprofit Transaction Processing Performance Council. Typically, server companies leapfrog each other when they come out with new models, but analysts say IBM may be able to sustain its lead.

SWARM OF GADGETS

IBM IS DOING EVEN whizzier things with supercomputers. In a radical shift, its new Blue Gene model uses tens of thousands of inexpensive embedded Power processors—the type used in cell phones. The company also produced chip innovations for cooling and speeding communications within the computer. The result: a machine that broke the supercomputing speed record late last year and still holds it. The first Blue Gene cost \$100 million, one third the price of the supercomputer it beat out.

Servers and supercomputers are familiar turf for IBM, but if it can hit a home run with Cell, it could vault into the lead in a promising new market. While the chip was originally conceived for PlayStation 3, due out in 2006, Cell is now aimed at a swarm of consumer devices—from high-definition TVs to mobile gaming gadgets. The Power technology is well suited to these applications because it's cool-running and, in the Cell design, capable of handling a deluge of demands—rich graphics, video processing, and real-time communications. If all of these efforts deliver as IBM hopes, the Power processor will finally live up to its name. ■

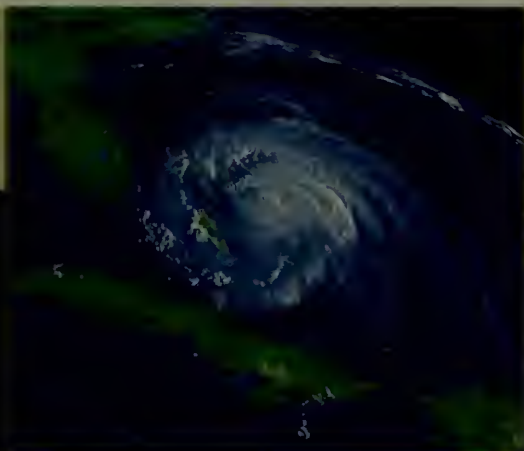
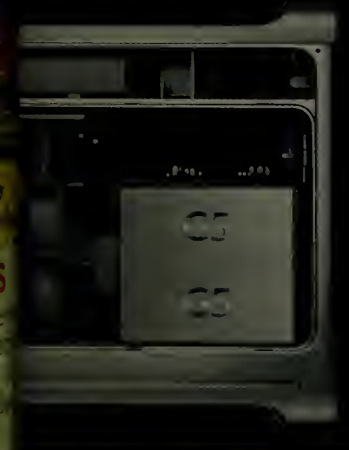
—By Steve Hamm in New York, with Ben Elgin in San Mateo, Calif.



A crucial goal for IBM: To halt Intel and AMD's advance

DESKTOP COMPUTERS

Apple with processors for its latest G5 series of desktop computers, which helped drive Apple's 26% increase in computer sales last quarter.



SERVERS

Power processors have helped IBM gain nearly 10% of the Unix server market over the past three years. Raytheon uses Power servers to analyze and distribute weather satellite data for U.S. government agencies.

GAME CONSOLES

IBM will be the processor supplier for all three next-generation video game consoles coming from Sony, Microsoft, and Nintendo. Analysts say this business could amount to 50 million processors, worth \$1 billion, in 2007.



High Stakes For Casino City

CEO Michael Corfman is suing the Justice Dept. over online gambling ads

EVER SINCE HE WAS A teenager in Washington State, Michael A. Corfman has had a penchant for questioning authority. At his Catholic high school in the late 1960s, Corfman worked on an underground newspaper that he and his friends decided to call *The New Protestant*. The paper ran several controversial stories, including one advocating a woman's right to an abortion. Another attacked plastics as an environmental hazard, distressing administrators since one of the school's top donors was a plastics company exec. "Mike is not afraid to say what he thinks is right," says Michael Schmitt, a friend who worked with Corfman on *The New Protestant*.

Now, Corfman is challenging the ultimate authority: the U.S. government. His online gambling portal, Casino City Inc., is suing the Justice Dept. in a high-stakes lawsuit that puts Corfman in the middle



FREE SPEECH
is the issue,
says Corfman

of a battle over the future of online gambling. Corfman is fighting for the right to run advertising from online gambling operations on Casinocity.com. U.S. prosecutors have claimed that online gambling is

illegal, and the Justice Dept. has sent letters to Web sites and broadcasters to accept such ads, informing them they will be aiding and abetting these illegal activities." Many companies, including giants Google and Yahoo!, as well as radio station owner Infinity Broadcasting, have stopped taking the advertising.

Not Corfman. He didn't even get one of the Justice Dept.'s threatening letters. Instead, he went on the offensive, hiring Barry Richard, one of the lawyers who represented George W. Bush in litigation in Florida after the 2000 presidential election. Casino City, a Las Vegas (La.) company that provides information about the gambling industry, depends entirely on online

advertising for its sales. What is the man's argument? That the government's campaign is a violation of the First Amendment's free speech protections. The First Amendment offers some protection for commercial speech, but it concerns illegal activity, says Corfman, and some independent attorneys, claiming that only sports betting on the Net has been clearly declared illegal in the U.S. that other wagers, on blackjack or bingo, are still permitted. "It is inappropriate for the government to use threats as a way to curtail free speech," says Corfman.

The nature of the Internet creates an additional layer of legal complexity because the Net is global, the ads on Casino City may be viewed by anyone, including people in countries where online gambling is legal. What right does the government have to stop Corfman from showing a Costa Rican casino's ads to a British gambler? Online gambling is permitted in many countries, including Australia, Britain, and Germany.

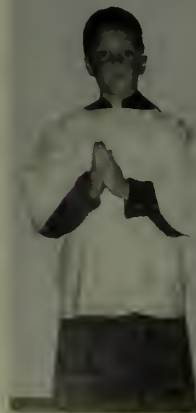
What's more, shutting down Casino City may simply drive its business overseas. If the U.S. government prevails in its battle with Corfman, hundreds of sites outside the U.S. will line up to advertise from the casinos that use the company. And those sites will be just as accessible to U.S. gamblers as Casino City. "The Justice Dept.'s position is not law and not good policy," says attorney Richard. A U.S. District Court in Louisiana is expected to rule on the federal government's motion to dismiss the case within the next few months.

Corfman isn't taking on Justice si

BIO

Michael A. Corfman

"It's inappropriate for the government to use threats."



BORN May 29, 1953, in San Diego. Oldest of seven children. Grew up in Des Moines, Wash.—midway between Seattle and Tacoma.

PARENTS Father was a pharmacist, and mother ran a card store.

CAREER Worked as a software engineer at several companies, including Digital Equipment Corp. Founded Information Technology Systems, parent of gambling portal Casino City, in 1990.

DICEY BET In his suit, Corfman is arguing that Casino City should be entitled to accept ads from online casinos, which the Justice Dept. contends are illegal. The suit came after other sites, such as Yahoo, stopped accepting such ads.

REBEL WITH A CAUSE In high school, Corfman helped put out an underground paper. In 1969 he was tear-gassed during a protest to protect People's Park in Berkeley, Calif.



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handed. The 51-year-old, who worked as a software engineer at Digital Equipment Corp. and other tech companies before founding his gambling portal 10 years ago, has solicited donations from online gambling companies and trade associations to help pay for the lawsuit. One of Corfman's financial supporters is Britain's Sportingbet PLC, *BusinessWeek* has learned. Sportingbet Chief Exec Nigel Payne confirms that his company has helped fund the case, but he says it has done so through a third party, which he declines to identify. Corfman, who won't specify how much money has been contributed, says he can't afford the lawsuit on his own, since Casino City makes a small profit on revenues of several million dollars.

A ROCK AND A HARD PLACE

LEGAL EXPERTS ARE sharply divided over the issues. Jennifer S. Granick, executive director of the Stanford Law School Center for Internet & Society, says it is significant that Casino City's ads reach people in countries where online gambling is legal. "On the Internet, commercial speech can be broader because the audience is a little broader," she says.

Yet the more likely outcome is that the government will prevail. Jack M. Balkin, a law professor at Yale University, says the federal government has the right to enforce U.S. laws on companies that operate within the country, even if their activities are international. And the U.S. courts don't have an interest in extending First Amendment protections to Web surfers beyond the country's borders. "I think [Corfman] is between a rock and a hard place," he says.

Corfman has a backup plan if his legal gamble is a bust. Since Casino City's advertising dollars would shift to another company, he plans to sell the site to an overseas company. The site, and its ads, would continue to be available to any Web surfer in the world.

Still, Corfman is far from backing down. "When he gets an idea and he knows he's right, there's no stopping him," says Patricia Steiner, a business consultant who is advising Casino City. When Corfman was an undergraduate at Massachusetts Institute of Technology, he drafted a petition to protest the Vietnam War. He worked for a month to get several thousand signatures, from students, alumni, and even MIT President Jerome B. Wiesner. This time, it's the Justice Dept. that may find Corfman's protest difficult to dismiss. ■

B. Spencer E. Ante in New York



READY FOR TAKEOFF
Russo with his \$18 million investment

How Do You Follow \$7 Billion Buyout?

If you're Carl Russo, you build Calix—an enable telecoms to deliver video cheaply

CARL RUSSO BECAME famous in tech circles in August, 1999, when his optical-networking company, Cerent Corp., was bought by Cisco Systems Inc. for \$7 billion—one of the highest prices ever paid for a privately held tech company. Two years later, after helping Cisco get its optical business booming, Russo decided to retire. He wasn't looking to relax, though. He wanted to devote himself full-time to his lifelong passion for driving Formula One-style race cars. He had taken the

wheel in dozens of races and loved the adrenaline rush of flying along at 180 mph. "It was time to go racing for good," says the 48-year-old Russo.

It didn't work out that way. When Russo didn't abandon the racing circuit, Cisco returned to the networking game a few years ago as chief executive of the now-known Calix Networks Inc. What brought him back was the opportunity to start around a struggling startup, in which he considers say he had invested more than \$20 million. Now Calix, of Petaluma, Calif., is burning up the track. Sales of networking gear, which lets phone c

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panies deliver video and Net services to people's homes without expensive upgrades, doubled last year, to over \$100 million, and the company is generating the kind of excitement rarely seen since the bubble days. "Calix is a hot company," says analyst Sam Wilson of JMP Securities. "It could be the next Cerent."

"RIGHT PLACE, RIGHT TIME"

NOT THAT RUSSO is headed for another \$7 billion bonanza. For the telecom world, those days are long gone. But just as Cerent helped pioneer the use of optical technology to shoot Internet traffic between cities and towns, Calix is on the leading edge of another megatrend. Telephone companies, desperate to head off competition from cable rivals, plan to spend billions over the next few years to upgrade their networks so they can offer TV along with voice services. Using Calix gear, which sits in apartment-building basements and the telecom cabinets that dot suburbia, phone companies can roll out such services just by adding an extra circuit card. "Carl is in the right place at the right time. This market is going to explode," says Frank Dzubeck, president of telecom consultant Communications Network Architects in Washington.

Serious challenges remain, to be sure. While Calix has signed up more than 140 phone companies, from tiny rural outfits to larger regional players such as CenturyTel Inc., it has yet to land one of the giant Bells. That's key for any communi-

cations-equipment company that wants to have a lasting impact—or a blockbuster public offering. And competition is rising fast. Market leader Alcatel recently landed a huge contract to help SBC Communications Inc. deploy its video-on-demand TV offering. "Carl is a smart guy, but this is a tough business," says Hilary Mine, Alcatel North America's senior vice-president for marketing.

Russo has faced tough challenges before. In college, he was an aspiring research physicist and "business was the furthest thing from my mind." Then, when he was 21, his mother died, six weeks after finding out she had leukemia. With Russo's grieving father too shaken to attend to his one-man electronics distributorship, Russo dropped out of college (he never graduated) and took over. "I bought every sales book I could find. Somebody had to keep an eye on the business," he says. "Although I almost figured out how to put it out of business."

That's classic Russo: Always quick with a wisecrack, he seems as much prankster as manager. There's a serious goal, however. "You've got to let people be themselves. If you don't, I don't know how you get the creativity you need, or the criticism." These days, new employees are often shocked to find him working

while sitting on the floor of his legs crossed Indian-style. "It's more comfortable—and it's amazing what happens when you put yourself in a physical position to people," he says.

His idiosyncratic style has paid off. He co-founded Cerent in 1997 and was ready to go public just two years later. It was when Cerent filed its financial statement with the Securities & Exchange Commission that Cisco came calling. While the deal was a stunner, most analysts say the

company was paid off in spades for Cerent Inc. Sales blossomed from \$100 million to about \$1 billion in 18 months, says an insider. Russo jokes that the money hasn't changed him—except for the front mansion in San Jose, Calif., and the \$18 million Cessna Citation X he bought.

His experience at Cerent hasn't been quite as smooth. The company was in trouble when he agreed to

become CEO in February, 2003. He just laid off half its employees and was struggling to deliver on its promises. Just days into the job, Russo got a call from Ringgold Telephone Co.—which had covered a glitch that prevented it from turning on a new TV service it had begun to advertise. Many startups have offered to take their gear back, but he left it at that. But Russo invested more than \$1 million to buy a rival's equipment to help solve Ringgold's problem. Then he worked with Calix' engineers to fix the bug. Says Ringgold Executive President Phil Erli: "I will forever be grateful to Carl's debt. It was a class act."

Russo engenders respect around the racetrack, too. In just two years his car team, called RuSPORT, has become a top contender in the Champ Car series, which is similar to Formula One. That's in part because of Russo's oversight. In a league in which most drivers are weekend hobbyists, Russo interviewed almost every member of the 45-person team, right down to pit crew. "He put a great deal of thought into it. He wanted this team to look like a team," says President Jeremy Dale.

As for Calix, investment bankers could easily do a public offering there. Still, Russo insists he's not looking to go public or sell out. "We're just trying to build a sustainable, good company. Frankly, we've got a lot of work to do," he says. Maybe so. But once again, Russo looks as if he's driving the pace car.

—By Peter Burrows in Petaluma

Calix has signed up 140 phone companies but lacks a major one

BIO

Carl Russo

The hard-driving entrepreneur likes speed—and making work enjoyable

BORN Nov. 4, 1956, in Englewood, N.J.

EARLY CAREER When his mother died suddenly of leukemia, the 21-year-old aspiring physicist stepped in to take over his grieving father's one-man electronics distributorship.

CLAIMS TO FAME In 1999 he sold his optical startup, Cerent Inc., to Cisco Systems for \$7 billion—one of the highest prices ever paid for a privately held tech concern.

HOPES FOR CALIX He insists that he's after neither an IPO nor an acquisition. Instead, he wants to build a long-lived company



that will make the equipment to deliver new byte-hogging video, voice, and data services to people's homes.

HOBBIES Professional car racing. His 45-person team, RuSPORT, has become a top contender in Indy-style racing. His goal: overtake the team of friend and rival Paul Newman, the actor.

MANAGEMENT PHILOSOPHY Keep things fun. "You've got to let people be themselves. If you don't, I don't know how you get the creativity you need, or the criticism."





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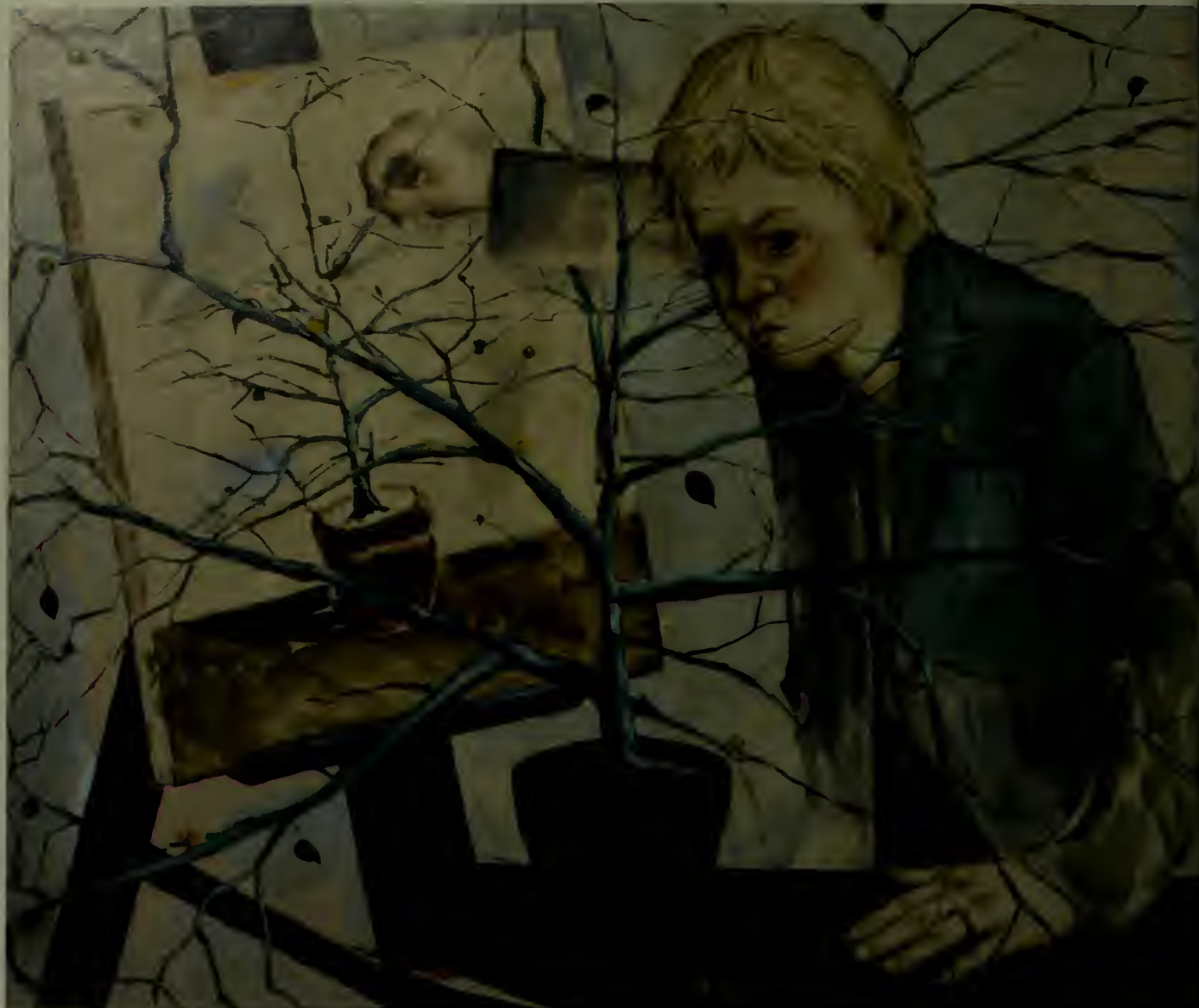
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Above: Edgar Bryan, *The Ledge*, 2004. Oil and acrylic on canvas. Private collection.

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Funds to Please The Eye

But with subjective valuations and steep costs, the new art funds look rather risky. **BY TODDI GUTNER**

ART IS HOT, BUT art collectors aren't the only ones generating heat. Financial investors looking to profit from esoteric art prices, aim to move into more of the market asset class—much as they did with real estate through real estate investment trusts starting in the 1960s.

Former Sotheby's Holding and Christie's International auction-house directors, bankers, and Wall Street investment managers have plans to launch at least a dozen investment funds in the first half of 2005. They will acquire works in various segments of the art market and hold them for up to 10 years (table). At least a half-dozen funds are expected to go public this year. The funds are targeting individuals with at least \$5 million in investable assets, private banks, hedge funds, offices, universities, and pension funds. Minimums start at \$250,000, but some sponsors are talking about even lowering the cost of entry to \$50,000.

With such activity, it didn't take long for Dutch bank ABN Amro to announce a fund of art funds. In addition to reviewing proposals from fund managers, ABN Amro wants to be included, "we're even looking for families in who want to add their art

JACKIE (1964)*
ANDY WARHOL

collections into investment funds," says Salama, global head of private banking at ABN Amro's wholesale client bank in London.

Enthusiasm like that usually hits the frothy market. "People outside the art world see the gains and want a piece of the action," says Mary Hoeveler, managing director of Citigroup Private Art Advisory Service. The rush into art funds gives some U.S. private banks, such as Citibank, JPMorgan, and UBS, a leg up. "We still view art as a collection as opposed to solely an investment," says Tony Werley, head of portfolio construction at JPMorgan Private Bank. Others cite the difficulty of valuing art, its lack of liquidity, high transaction costs, and volatility as obstacles to investing in art for purely financial gain.

Still, high-net-worth investors,

*These works are representative of the type of pieces The Fine Art Fund would buy, though they are not currently in the portfolio.



GRAND CANAL
(13-1724)*
VINI ANTONIO
NALETTO

ited by lackluster returns on stocks and bonds, may respond to the art-fund pitch.

Numbers support the case to invest in the proxy for the broad art market, the *Moses Annual All Art Index*, has a compound annualized return of 7%, vs. 10.95% for the Standard & Poor's 500-stock index. (The *Mei/Moses* index is only four years old but draws from more than 8,000 repeat art sales, including New York auction records going back to 1875. Keep in mind that transaction costs will reduce the return on art.) From 1999 through 2004, the index returned 7.27%, vs. 10.95% for the S&P 500. Perhaps the selling point is "that art has a relation with stocks and bonds," says Michael Moses, a management professor at New York University's Stern School of Business

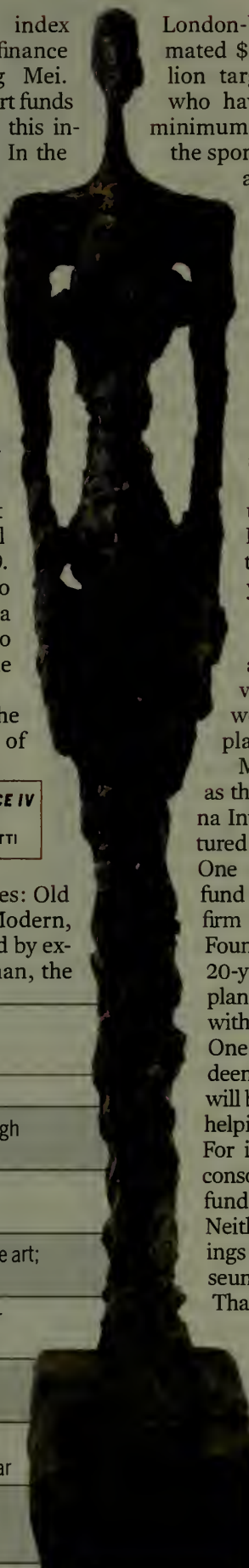
who created the index with Stern finance professor Jianping Mei.

The new crop of art funds isn't the first to try this investment approach. In the mid-1970s, British Rail Pension Fund put \$100 million, or 2.5% of its portfolio, into art. The fund amassed a broad collection of 2,400

pieces, from Chinese porcelains to African tribal art. The portfolio wound up with an annual compound return of 11.3%, but the gains came primarily from 25 Impressionist paintings. The fund sold off all of its art from 1987 to 1999. "We tried to diversify too much," says Jeremy Eckstein, a former adviser to the fund who is consulting with some of the new players.

To avoid overextension, The Fine Art Fund, the biggest of the new ventures, plans to buy no more than 500 works in four categories: Old Masters, Contemporary, Modern, and Impressionism. Founded by ex-Christie's exec Philip Hoffman, the

WOMAN FOR VENICE IV
(1956)*
ALBERTO GIACOMETTI



London-based fund has raised an estimated \$100 million of the \$350 million target from qualified investors who have ponied up the \$250,000 minimum. Sources close to the fund say the sponsors are looking for an annu-

al return of 10% to 15%, though they expect to make as much as 100% on some paintings. Similar to a hedge fund, investors will have to deduct a 2% annual management fee (in this case to help cover insurance, storage, and maintenance for the art). Plus, there's a 20% performance fee from the profits if the annual return exceeds 6%.

Investors' money is locked up for the fund's 10-year life. Profits and capital will be distributed starting in the third year. The fund plans to generate income by allowing its investors to rent works valued at up to three times their investment. Fund organizers won't say how much rent they plan to charge.

Most of the other ventures, such as the American Art Fund and China Investment Fund, are also structured as closed private equity funds. One exception is an open-ended fund from Boston-based advisory firm Fernwood Art Investments. Founder Bruce Taub, a collector and 20-year veteran of Merrill Lynch, plans to launch two funds this year with an estimated \$150 million. One will let investors buy and redeem shares twice a year. The other will be closed, with half of its capital helping to finance art transactions. For instance, the fund may join a consortium of investors organized to fund a quick buy and sale of a piece. Neither portfolio will rent its holdings but both will lend pieces to museums or important exhibitions. That way, "the value of the art will be enhanced through exposure," says Taub, who won't disclose fees or investment minimums.

All of the art funds plan to give investors a yearly statement with a professional appraisal of the art in their portfolios. "But that value means noth-

On the Drawing Board

	DESCRIPTION
AMRO amro.com/wholesale	Launching an art fund-of-funds to be sold through private banks
AMERICAN ART FUND 5-4761	Seeks to raise \$100 million by yearend to buy and sell American fine art
CHINA INVESTMENT FUND 20 7828 7230	Hopes to raise \$100 million to purchase Chinese art; plans a second-quarter launch
POSTWAR AND CONTEMPORARY ART FUND 33 744 5050	March, 2005, launch with up to \$200 million for postwar and contemporary art
FERNWOOD ART INVESTMENTS fernwood.com	Raising \$150 million for a sector fund to buy art and an opportunity fund to do deals
THE FINE ART FUND fineartfund.com	In the process of developing financial products for the art market to be announced later this year
THE FINE ART FUND fineartfund.com	Has raised \$100 million of a planned \$350 million to invest in four categories of art

ing," says Lord Mark Poltimore, chairman of 19th and 20th century pictures in Europe at Sotheby's. "No one really knows what something is worth until the auction hammer goes down and the piece is sold."

It is precisely that arbitrary nature of the investment that makes Wall Street nervous. Critics of art funds argue that art indexes can be misleading because they don't take the considerable transaction costs into account. Works sold at auction normally carry both a buyer's and seller's premium of 10% or more, and dealers can charge as much as 50%. "Art funds may be able to negotiate with auction houses to drive the commissions down, but that isn't clear yet," says Karl Schweizer, head of art banking for UBS Global Asset Management in Basel, Switzerland.

WHO DECIDES WHAT'S HOT?

ANOTHER PROBLEM with most analyses of the art market is that they account only for art sold at auction. While no one knows exactly what the breakdown is between private deals and public sales, "a huge sector of the market has no transparency and can't be analyzed," says Citibank's Hoeveler. Plus, "only paintings in broad enough demand to attract competitive bidding are offered at auctions," she says. That demand is extremely subjective, typically driven by a handful of collectors and dealers who decide what's hot. For every record-setting sale, there are pieces withdrawn from the market because bidding doesn't meet the seller's minimum price.

Liquidity in the art market is limited, and prices can go down, too—even for the works of great artists. For instance, Pierre-Auguste Renoir's *A Young Woman Bathing* sold at auction for \$11.3 million in 1997. Seven years later, it went for \$7.3 million.

Despite the drawbacks, art fund fans say it's just a matter of time before U.S. investment advisers climb aboard. Those on the fence can learn more in early April at a conference Christie's is hosting in New York. "Interest is coming mainly from Europeans now," says ABN Amro's Salama. "U.S. managers are taking a wait-and-see approach." Individuals would be wise to watch from a distance as well. ■

—With Kerry Capell in London

BusinessWeek online

For more on investing in the hot art market, please visit us online at www.businessweek.com/extras



BRAWNY The V-8 engine delivers plenty of juice

One Pricey Rover

The new LR3 cures its predecessor's ills, but are upgrades worth the sticker shock? **BY DAVID WE**

FORD MOTOR ACQUIRED Land Rover from BMW in 2000, and industry watchers saw the deal as a mixed bag. Land Rover's unique SUVs had snooty British cachet, but the vehicles were sluggish, overpriced, and at best, mediocre.

The new Land Rover LR3 cures most of those ills, but it's still pricey. The LR3, the unfortunate new moniker for the old Discovery, is about the size of a \$28,000 Ford Explorer, but it starts at \$45,000, 32% higher than the Discovery. My test version was \$53,000.

True, it's a technological showcase. The Terrain Response system is a nice feature that makes the SUV a real off-roader. With the turn of a knob, the suspension, traction control system, and throttle can adjust to handle almost any kind of terrain. It toggles from standard-drive mode to four others, including one for snow and slick pavement, one for mud and ruts, a sand and gravel mode, and a setting for driving over jagged rocks.

All that off-road wizardry may not be necessary

Is the wizardry necessary? After a fresh snow fell on my unplowed driveway, I rolled through the neighborhood out shifting the vehicle into any of the four terrain modes. It handles decently in normal drive just fine.

On the highway, the LR3 is good. The Discovery would have been frighteningly unstable when changing lanes at 60 mph. I wouldn't have been aggressively swerving in and out of lanes, but in ordinary driving, the LR3 handles well. The suspension provides a smooth ride.

The interior, however, is not what you'd expect. Land Rover says the plastic dashboard is resistant to fading in sunlight. But the battleship-gray plastic in my test model was flat-out ugly. It doesn't look like something better than a \$50,000 SUV and isn't in the same class as the Land Rover's flagship Range Rover, which has one of the most beautiful and luxurious cabins in the business. The LR3 starts at \$74,000. The LR3 is roomy, but has a \$1,250 option for a third row, making it a seven-passenger vehicle. The seating is a little too upright.

All in all, the LR3 does what a Land Rover promises. The 300-horsepower V-8 has more than enough juice. The question is whether to shell out more than \$50,000 for some off-road driving you may never use. ■

Don't Write Off That Tax Write-Off

Consultant June Walker tells the self-employed to be
anxious about deductions.

MANY SELF-EMPLOYED people, the line between work and
personal life isn't always clear. Tax and financial consultant
June Walker, author of *Self-Employed Tax Solutions* (Globe Pe-
terson, \$17.95), argues that the confusion often causes people to
leave themselves out of legitimate deductions. *BusinessWeek*
personal-finance writer Suzanne Woolley quizzed Walker, who
has 25 years of experience and works out of her home in San-
Antonio, N.M., about ways to make self-employment less taxing.

Can the self-employed write off too

often cheat themselves by consider-
ing an expense personal when it's really a
business expense. In the corpo-
rate world, it's clear who is a
business associate and who is
not. For the self-employed, that
line is very wiggly. Just because
someone is a friend or a family
member doesn't mean he or she
is a business associate.

**Can you say that a gift
from Mom can be a legitimate
deduction. How so?**

Your mother watched the
kids because the baby-sitter
showed up and you had to do
an interview. You thank her by
giving her flowers. You can write
off. (The limit is \$25 per
gift.) You note on the receipt
that it was a gift for Mom be-
cause she watched the kids
while you did an interview.

You say an information-tech-
nology consultant is going out
of town, and her husband is
going to the business. They have
kids. She wants him to
pay out a business plan, so
she goes out to dinner. She can
write the dinner off even though

it's with her husband. She couldn't have
had that dinner at home with the kids
around. You can't write off every dinner,
but if there is a business motive, you can.



WALKER Look
for a possible
business
angle in all
your
spending

**What is the mind-set you say self-
employed taxpayers need to adopt?**

Look at everything that you do as a possi-
ble business connection and define your
business as broadly as you can. You
might define what you do as tech consult-
ing rather than computer repair. If you're
a writer who is a generalist, you can write
off a lot more than if you write only about
sports.

**The Internal Revenue Service says an
expense must be "ordinary and
necessary." What does that really mean?**

The IRS defines necessary as "appropriate
and helpful." What counts as ordinary? If
a computer game developer buys other
people's games, that's an ordinary ex-
pense to him. It's not an ordinary expense
for me unless I'm writing and have the
potential to write about computers or the
effects those games have on the brain.

**Why do you advise clients not to
incorporate?**

It's expensive, it complicates your self-
employed life, and in most cases, it's not
necessary. Often the money spent on in-
corporating would be better spent on in-
surance, such as liability insurance.

**The conventional wisdom is that claiming
a home-office deduction triggers an audit.
Is that true?**

So what if they audit you? If you have
good record-keeping, an audit's nothing.
Also, office-in-the-home regulations have
been liberalized. Say an info-tech con-
sultant shares an office in town with an-
other consultant and has computers
there because she lives in a small apart-
ment. Of course, she can deduct rent for
the office. But as long as she has a place at
home used exclusively for work—suppose
she bills from there—she can write off
that area, though it will be a small write-
off. More significant is the deduction she
will be allowed to take for travel between
the two offices. If she didn't have the
home office, she couldn't take that deduc-
tion.

**What big mistakes do the self-employed
make regarding their taxes?**

Everybody thinks taxes have to do with ex-
penses. Many people lose sight of the need
to track their income. They may not realize
if the client makes a mistake in reporting
to them and, more important, to the IRS.
You need to keep your own records, too. ■

BusinessWeek online For the full interview
with June Walker, go to
www.businessweek.com/extras.



TRULLI
CENTRAL
Shopping in
Alberobello

Valle D'Itria, you'll find round trulli, round houses with conical roofs built in the 16th centuries. Most have symbols scrawled on the walls to ward off evil spirits, and topped with a pinnacle, the builder's signature.

STONE WALLS

LEGEND SAYS Apulian trulli because the thick walls kept the buildings cool in summer and warm in winter. In reality, an unheated trullo is damp and chilly in the winter. The design did have one advantage: The French, who ruled southern Italy at the time, could not levy taxes on unfenced buildings. That meant trulli could not be dismantled when tax collectors came to town, then immediately reconstruct them.

One of the best places to see trulli is Alberobello. A UNESCO World Heritage Site, the town looks like a film set for *The*

stones Go to Italy. The narrow, winding streets are lined with more than 1,000 trulli. There's even a trullo church. Some of the trulli are still people's homes, evidenced by the women shelling pistachios on the front stoops.

Outside Alberobello, many trulli have been transformed into small hotels or holiday homes. A trullo with two or three cones costs about \$120,000 to purchase and modernize. I stayed at Acquarossa, a converted trullo about 10 miles from Alberobello. The hotel offers five suites, each with its own kitchen and sitting room. Prices, including a hearty breakfast of zucchini fritters, mint frittata, fresh fruit, cheese, pasta, and homemade fig jam, are \$65 a night in high season.

Farther south, visit Lecce, known as the "Florence of the Baroque." During the 17th century, when Lecce served as the provincial capital, the city became a mini-Versailles, attracting nobility who competed to design the most ostentatious palaces and chapels. The buildings were adorned with ornate carvings, made possible by Lecce's soft, honey-colored

Who Needs Tuscany?

Apulia, the heel of Italy's boot, is beautiful, affordable—and not overrun with tourists. **BY JANE BLACK**

NORMALLY IT WOULD take a lot to persuade me to eat horse meat. But the food in Apulia—the heel of Italy's boot—hadn't let me down yet. So when the owner of the restaurant Gia Sotto L'Arco in the baroque town of Carovigno suggested it, I didn't flinch. It arrived, aromatic strips of grilled meat on a mound of arugula with a crisp baked potato and a drizzle of peppery olive oil. I took a bite and chewed as I gazed over the gleaming marble piazza. Sweet. Gamey. Divine.

That meal—and nearly everything else in Apulia—surpassed expectations. The region is known for its golden beaches, grand baroque churches, quirky beehive-

shaped stone houses, vineyards, olive groves, and gastronomical delights. Yet it is not overrun with tourists, as are popular areas such as Tuscany. And real estate is still relatively affordable, which is why foreigners, especially the British, are starting to snap up run-down villas.

Warm between April and October, Apulia has a coastline that stretches hundreds of miles along a clear azure sea. Conveniently, the main tourist attractions are centered in the 65-mile stretch between the capital Bari and port city Brindisi. (Bari itself is 300 miles from Rome, a one-hour flight.) Here, in the





STYLE Throughout the city, you'll find an excess of sumptuous cornices, decorative columns, grotesque cherubs, carved baskets of flow-fruit, and fluttering ribbons. The intricate carvings of animals, plants, flowers at the recently restored facade of Santa Croce are the best example of the Lecce style.

D FARMHOUSE

REMAIN two key differences between Apulia and better-known Italian regions. First, Apulians haven't been bedazzled by a crush of tourists, so they're the friendliest people I've met here in the country. On two occasions when I asked driving directions, for example, a local jumped in his car and insisted I follow him there. Second, prices, even with an unfavorable exchange rate for Americans, remain reasonable: A meal at La Taverna del Duca, a trattoria in the whitewashed town of Locorotondo, cost \$15, while a feast of 22 local seafood specialties at Antichi Sapori in Montegrosso, near Bari, came to just \$41 a head. Money is no object, indulge yourself at one of the half-dozen new resorts along the coast. I loved the two-day stay at Masseria Torre Coccaro, a 17th-century house set in an olive grove which has stylish rooms that start at \$347 a night in summer. Guests can go horseback riding, play golf, take a cooking class with the chef, or relax at the Aveda spa (www.masseriatorrecoccaro.com). The arrival of such grandeur is evidence that Apulia is well on its way to being discovered. But if you go, you'll still enjoy an authentic experience through one of Italy's most interesting regions. ■

New Cachet for an Old Wine Region

Apulian estates are winning praise as cheap acreage draws savvy vintners. **BY JANE BLACK**

APULIA PRODUCES 17% of Italy's wine, enough to make it the world's sixth-largest winemaking region. Yet until recently, much of Apulia's red wine was used to bulk up wines from Tuscany, Piedmont, and even France during a poor harvest. Whites were sent to Turin to be distilled into vermouth. Today, Apulian estates are distinguishing themselves, profiting from unique varietals, old vines, cheap land, and an influx of winemakers. In August, Robert Parker's influential *The Wine Advocate* scored nine Apulian wines at 91 points or higher, an "exceptional" rating.

Apulia's new guard includes Vahé Keushguerian, president of La Corte winery. A former restaurateur in Berkeley, Calif., Keushguerian moved to Tuscany in 1996 and began making wine. Two years later he purchased 55 acres in Apulia planted with the local varietals negro amaro and primitivo. Now, La Corte's \$30 top blend, Re, has won international acclaim. "It's the best wine I have ever tasted from this part of Apulia," says *Wine Advocate's* Daniel Thomases.

Northern Italian winemakers, who once turned down their noses at their southern brethren, have made the biggest investments. Avignonesi of Siena and Gruppo Italiano Vini of Verona have both snatched up 100-acre to 200-acre properties. Tuscan wine dy-

nasty Antinori, which bought nearly 1,500 acres, markets four reds from that estate under the brand Tormaresca. It's producing 1.2 million bottles a year and aims to double that by 2007.

The outsiders have brought modern production techniques, hygiene, and refrigeration to Apulia, not to mention marketing and distribution knowhow. "People thought negro amaro had a cooked flavor and a barnyardy aroma," says Gianluca dell'Antoglietta, Tor-

maresca's marketing director. "In fact, it was just poor winemaking." Tormaresca's best—the 2001 Bocca di Lupo, made from the local aglianico grape, and the 2001 Masseria Maime negro amaro—retail for about \$25.

Apulia's real strength is in everyday wines, says Severino Garafano, a wine consultant who makes wine at his estate, I Monaci. Its 2001 Censi, a blend of negro amaro and primitivo, has a *Wine Ad-*

vocate rating of 88 and retails for just \$11.

Apulia has made great strides in the past five years, says Sergio Esposito, owner of New York-based Italian Wine Merchants. Although he steers clients toward northern Italian wines for special occasions, he believes Apulia has "more potential to make great wines than unknown producers in northern Italy or Bordeaux." That is nothing to sniff at. ■

I MONACI'S 2001 CENSI
Negro amaro and
primitivo blend
Hints of cinnamon and plum
\$11

LA CORTE'S RE
Negro amaro
Panoply of fruit,
coconut, coffee, mocha
\$30

TORMARESCA'S 2001
MASSERIA MAIME
Negro amaro
Plum and blackberry
flavors
\$25



Hike Your Odds On a Vegas Condo

They're going up all over the Strip—and not every project will be a winner. **BY CHRISTOPHER PALMERI**



DURING THE DEC. 16 finale of last season's TV show *The Apprentice*, Donald J. Trump unveiled a model of his first Las Vegas condominium tower. Trump began taking \$10,000 deposits that night and within a month had reservations for 80% of the 1,282 units, at prices around \$1,000 per square foot. In January he announced plans for a second tower. "Everybody wants to be in our building," The Donald told *BusinessWeek*.

Trump's boasting aside, Las Vegas has become one of the hottest condo markets on the planet. Developers are filing for permits on 30 high-rises and are considering building 50 more. The condos, most of them along the city's famed Strip, start at \$350,000 for one-bedroom units and run into the millions—sky-high prices in a city where the average condo sells for

\$203,000. The volume of projects amazes even boosters of a city that prides itself on excess. "I went to a groundbreaking the other day," says Las Vegas Mayor Oscar Goodman. "Half the units were spoken for. People don't even know what their views will be. I never saw anything like it."

Trump isn't the only big name in the game. MGM Mirage has sold \$600 million worth of condos adjacent to its MGM Grand Las Vegas hotel and casino. Stars are joining the party, too. Actor Leonardo DiCaprio recently spent \$1.5 million for two adjacent two-bedroom units at Panorama Towers, a two-building complex under construction west of MGM's Bellagio Las Vegas hotel and casino.

Buyers need to be wary. Not all of the proposed projects will get built. It's important to ask about the track records of the developers and check references at

their other projects. You can secure with a \$20,000 refundable deposit. Developers will ask for 10% of the price when you sign a firm contract. More at groundbreaking, and 10% when the roof goes up—all nonrefundable.

As always, location is crucial. A tiny lot next door may sprout a view of a new tower. There's also a risk construction frenzy will create a glut that depresses prices.

RENT IT OUT

THE VEGAS CONDO boom began years ago when Turnberry Associates, a Miami-area developer, began selling its first of its towers. Turnberry brought luxury features from its South Florida projects

such as a wood-paneled house, limousine service, elevators that open to the doors of each unit. At the time, many developers thought buyers used to getting free parking wouldn't buy condos, but Turnberry proved them wrong. Buyers can feel harassed by the "nos," says Turnberry president Jeffrey Soffer. Early buyers have been winners. A two-bedroom, 1,500-square-foot unit in Turnberry's first building sold for \$290,000 in 1999. An identical unit in their latest tower sold for \$745,000.

Many of the proposed projects are "hotel condominiums." These are individually owned units that owners can opt out like hotel rooms when they're not in town. At the majestic Las Vegas, a 59-story tower planned on land just south of the Riviera Hotel & Casino, a 480-square-foot studio unit sold for \$400,000. The condos come

fully furnished, with Viking appliances and flat-screen TVs. Maintenance fees are \$450 a month. The property will be managed by Conrad Hotels, the luxury division of Hilton Hotels. Condo owners own 60% of any room revenue.

Since many condos are bought by investors, buyers who don't want a constant flow of tenants next door should look for projects that restrict rentals. Buyers of hotel condos, on the other hand, should make sure the property is managed by an established hotelier and adjacent to a popular casino that can generate a constant flow of customers. Remember, real estate booms always end. And Las Vegas has a long history of separating sucker from their money. ■

TURNBERRY TOWERS These units have soared in value since '99

ED BY TODDI GUTNER

SPIRITS

A HUDSON VALLEY KIR ROYALE

IF YOU WANT MORE than a glass of plain bubbly for Valentine's Day, try a Kir Royale using champagne and cassis made in New York's Hudson Valley. Most cassis, a black-currant liqueur, is imported from France. But one of the best—at \$35 a bottle—comes from **Clinton Vineyards**, and it only recently became widely available. Clinton was the first American vintner to produce cassis after the lifting of a decades-long ban on growing black currants in the U.S. (The berries once carried a fungus poisonous to white pine trees.) If cassis is to your taste, go for one of the state's dessert wines: Embrace, or Romance. —Gerry Khermouch

UAL FUNDS

THEY'RE EASY ON THE CONSCIENCE

ETHICALLY RESPONSIBLE exchange-traded (ETFs) are here. **Barclays Global** launched iShares KLD Select Index Fund on Jan. 28, while the iShares WilderHill Clean Energy Fund is awaiting Securities & Exchange Commission clearance. The fund, which shuns tobacco and alcohol, is a broadly diversified ETF that aims to match the risks of the Russell 1000 stock index. The fund overweights companies that score well on its screens, such as **Wells Fargo** and **Fannie Mae**. The **PowerShares** ETF, meanwhile, will focus on alternative energy. With expense ratios capped at 0.60% for iShares and 0.50% for iShare, the funds are cheaper than many comparable equity funds.



TRUSTS

No Prenup Needed

SINCE NEARLY 50% of first marriages end in divorce, wealthy parents often push prenuptial agreements on their kids before they marry. But there may be a better way to protect your kid, says James Kronenberg, principal at **Bessemer Trust**: Put the inheritance into a discretionary, irrevocable trust. Such a trust can be drafted long before anyone pops the question. As long as the money is inside a proper trust, it's off-limits to creditors, including former spouses. A caveat: Once money is distributed to your child, it's no longer protected. To shield the money, give the trustee full discretion to decide when to make payouts.

If a bride or groom's wealth is self-made, a prenup may still be needed. That's because until recently, it has not been possible for a person to set up a trust for his or her own benefit that protects against creditors, including ex-spouses. Seven states—including trust-friendly Alaska and Delaware—now allow trusts that have this sort of protection, and residency is not required. Be forewarned, though, that such trusts are untested in the courts, and some have exceptions that allow ex-spouses to get access to the money.

—Anne Tergesen

INVESTING

STOCKS SANK in January, which according to the pundits does not bode well for the rest of the year. But the market does have a second chance if you look at the gross domestic product. According to an analysis by Voyager Asset Management in Minneapolis, the Standard & Poor's 500 index usually performs well—an average **20.1% gain—in the 12 months following a year of at least 4% growth in GDP**. Since GDP was up 4.4% in 2004, don't be too quick to write off 2005.

YEAR	GDP GROWTH*	NEXT YEAR S&P 500
1978	5.6%	18.6%
1983	4.5	6.3
1984	7.2	31.7
1985	4.1	18.7
1988	4.1	31.7
1994	4.0	37.6
1997	4.5	28.6
1998	4.2	21.0
1999	4.5	(9.1)

*Including reinvestment of dividends
Data: Voyager Asset Mgmt. Business Week



BY ROBERT BARKER

Apple: It May Be Too Late to Take a Bite

If the Bush Twins, Barb and Jenna, accessorize with iPods, as some gawkers said they had amid Daddy's inaugural celebrations, does that make the iPod more cool, or less? What about

President Bush himself, who was seen iPoding late last year as he went for a bike ride? Did that spur iPod's monster holiday sales?

Silly questions, yes, but they are some of what now passes for investment analysis of Apple Computer, maker of the iPod line of music players and the stylish Macintosh family of computers. Lately hitting a new high above 77, stock in Apple is not just high-priced—37 times this year's estimated profit—but high-fashion. Which got me wondering: Besides a reflected glow as part-owner of today's most glamorous gadgeteer, what does 77 a share get an Apple buyer?

LET'S GO FIRST to the balance sheet. Impressively, 28 years since incorporating, Apple has no debt, long- or short-term. At last report, it had just \$8.52 a share in total liabilities, mostly accounts payable. Those liabilities are easily covered by \$22.34 in assets, including no less than \$15.39 a share in cash and short-term investments. All in all, Apple's stated net worth is \$13.82 a share. That probably undervalues Apple's



FIRST FAN

The President sported an iPod on a bicycle ride last year

real estate, which includes its Cupertino (Calif.) headquarters, plants in Sacramento and Ireland. Adjusting generously, we can guesstimate that one share contains \$20 in net assets.

For a buyer of Apple at 77, that leaves \$57 to wonder about. But could hardly be better: In the past four quarters, sales grew 45%, to \$1.28 billion, as net more than tripled to \$508 million, or \$1.28 a share, according to the Capital IQ, a database of Standard & Poor's. With new products such as the \$99 iPod and the \$499 Mac mini winning reviews (page 20), bulls see Apple blowing away Wall Street's conservative estimate of \$2.05 a share in the next four quarters. Suppose it does, earning \$2.45, the mean estimate not for calendar 2005, but for 2006.

That still leaves Apple trading at 31 times earnings, versus 15 for Dell Computer.

Does this mean investors won't keep paying 31 times earnings for Apple's extravagant estimates of future profits? No. But it's worth recalling what happened to eBay, another great company whose shares went in weeks from 118 to 80 on hints of slowing growth. Were something similar to befall Apple, all the cash on its balance sheet would act as a cushion. But that cushion is not as cushy as it was. Apple closed fiscal 2002 with earnings per share to cover 82% of its stock price. The next year the figure was 57%, and it was 35% last September at the end of fiscal 2004. Today, cash per share comes to less than 20% of Apple's stock price.

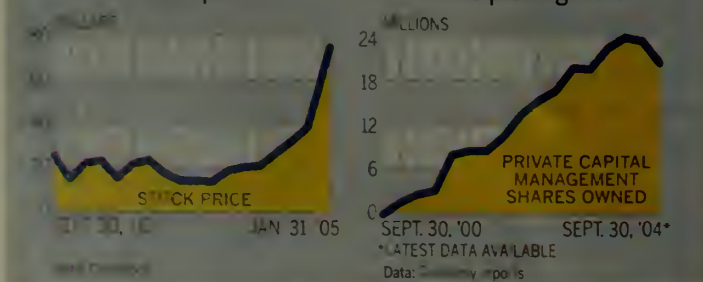
There is a season when investors who appreciate risk go for stakes in technology stocks. A case in point is Private Capital Management, a \$25 billion Naples (Fla.) firm that since 1991 has rolled up annual average returns of more than 20%, versus 12% for the S&P 500-stock index. Back in late 2000 (when Apple's cash covered 78% of its share price), PCM began buying Apple. It owned more than 6% a year ago. Then, as the stock took flight, PCM became a seller (charts). CEO Bruce Sherman told me that PCM must show its year-end position in a public securities filing due in mid-February. Apple does tempt me. If it did I would be more interested in that film about the First Family's latest gadget. ■

E-mail: rb@businessweek.com

SWEET MOMENT

As Apple's stock ripens...

...its largest stockholder starts picking fruit





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of Fund	1 Yr.	5 Yrs.	10 Yrs.	Life of Fund	Inception Date
(TWVLX)	14.36%	11.46%	14.05%	12.99%	9/1/93
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Income (TWEIX)	12.53%	12.51%	15.34%	14.74%	8/1/94
500	10.88%	-2.30%	12.07%	—	—

Annual total returns as of 12/31/04

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BY GENE G. MARCIAL

INTEL MAY BE ON THE PROWL FOR A PARTNER IN TELEPHONES.

THE FAX AND NET BUSINESSES ARE THRIVING AT BROOKTROUT

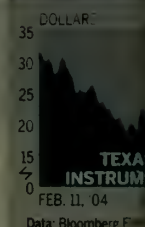
AS THEATERS SWITCH TO IMAX, THE STOCK IS RIPE FOR A BUY

Intel: Making Cell Calls?

WITH INTEL (INTC) STRUGGLING to crack the white-hot cell-phone business, some pros say it has little choice but to buy its way in. Names that pop up include Qualcomm and Analog Devices, which already collaborates with Intel on cell-phone technology. But attempts with Analog "have met with limited success," says Krishna Shankar of JMP Securities. The plum catch, he asserts, is Texas Instruments (TXN). It dominates in baseband processors—"the brains of wireless audio-signal processing," for global cellular standards. "Intel is eager to extend its franchise beyond micro-processors, and Intel and TI would be an ideal match," says Stephen Leeb, president of Leeb Capital Management, which owns shares in both. "Intel hasn't been able to translate its success into cell phones—TI's stronghold," says Leeb. Shankar says that Intel on its own doesn't have extensive cell-phone

software or the expertise to compete. TI is also a leader in digital-signal processing chips and software for processing voice and video. Qualcomm is big in the CDMA wireless market used by Verizon and Sprint. With its solid balance sheet and market value of \$144 billion, Intel, trading at 22 a share, can easily gobble up TI, with a market cap of \$40 billion and a stock price at 23. Both are off about 30% from their 52-week highs. An Intel-TI deal may raise regulatory issues, warns Shankar, who owns both stocks. He sees TI earning \$1.05 a share on \$12.5 billion in 2004 and \$1.25 on \$13.3 billion in 2005. He says it is "cautiously optimistic" that it can gain market in cell phones and compete without having to buy another company. TI declined comment.

TI—IS IT ON INTEL'S RADAR?



Data: Bloomberg Finance



The

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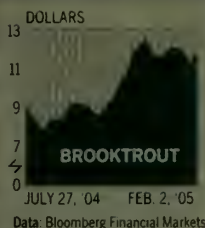
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Brooktrout May Be a Catch

PIONEER IN THE FAX business, Brooktrout (BRKT) could be a rich dish for investors, says Greg MacArthur, president of tech consultants McInt2000, who sees it as an emerging player in the growing market for Internet protocol (VoIP). The business is igniting fresh interest in the stock, he says. As its core fax business continues to sell, Brooktrout's focus shifts with its "SnowShore" media technology, which offers Internet connectivity for video messaging and streaming, opens up other opportunities, says MacArthur. In 2004, the stock rose from 6 to 12. Now, he sees the stock, now at 11.81, hitting 18. Mike McGrath of Raymond James & Associates, who rates the stock a buy, expects earnings of 23¢ a share in 2005 and 49¢ in 2006, after an estimated loss of 13¢ in 2004. He says the rise in R&D spending is helping boost the fax business, which accounts for 60% of Brooktrout's sales. And as the Web phone market grows, Brooktrout could materially increase its sales.

RISE TO THE BAIT



Breathtaking at Imax

WITH MORE MOVIE operators converting to Imax screens (which are often eight stories high and 120 feet wide)—in China, India, and Russia, as well as elsewhere—shares of Imax (IMAX) are drawing investors. A

pioneer in sound and projection for giant screens, Imax' format lets theaters convert their 35mm films into the 70mm Imax system. Shares have more than doubled, from 4.50 in August to 10.02 on Feb. 2, driven by the rise in the number of theaters signing up for the Imax format. Bernie Schaeffer, CEO of Schaeffer's Investment Research, which owns stock, notes that the shorts, expecting Imax to face cash-flow woes, have sold the equivalent of 16% of shares outstanding. That, plus Imax' strong upside action, sets up "a potentially explosive backdrop for further gains." An added plus: Imax is a takeover target for entertainment giants or private equity firms that have already acquired theater chains, he says. Sony, Time Warner, and Walt Disney were among the suitors when Imax was up for sale in 2000. But it took itself off the market when the allure of the movie-theater business faded after a rash of theater-building. Richard Ingrassia of Roth Capital Partners figures Imax will earn 24¢ a share in 2004 and 34¢ in 2005, vs. 2003's 14¢. He rates the stock a buy. CEO Brad Wechsler says Imax signed 35 new agreements in 2004 and expects 40 to 50 in 2005. Currently, there are about 240 Imax formats in place in 35 countries. ■■

TWICE AS HIGH AS IN AUGUST



BusinessWeek online

Gene Marcial's Inside Wall Street is posted at businessweek.com/today.htm at 5 p.m. EST on the magazine's publication day, usually Thursdays.

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STOCKS



COMMENTARY

Merger activity and strong earnings lifted stocks. P&G's \$57 billion buyout of Gillette, along with SBC's "smaller" \$16 billion takeover of AT&T, signalled a shift in corporate thinking. Meanwhile, Google turned in a gangbuster performance, with earnings jumping tenfold, while net income at stent-maker Boston Scientific doubled. All the markets ended the week in positive territory.

Data: Bloomberg Financial Markets, Reuters

U.S. MARKETS

	FEB. 2	WEEK	% CHANGE YEAR TO DATE	LAST 12 MONTHS
S&P 500	1193.2	1.6	-1.5	5.1
Dow Jones Industrials	10,596.8	0.9	-1.7	0.9
NASDAQ Composite	2075.1	1.4	-4.6	0.6
S&P MidCap 400	654.1	2.6	-1.4	11.1
S&P SmallCap 600	326.0	3.1	-0.8	17.3
DJ Wilshire 5000	11,752.3	1.8	-1.7	6.3

SECTORS

	FEB. 2	WEEK	% CHANGE YEAR TO DATE	LAST 12 MONTHS
BusinessWeek 50*	701.4	1.6	-0.5	11.3
BW Info Tech 100**	358.6	1.8	-3.9	0.1
S&P/BARRA Growth	574.1	1.6	-1.4	1.1
S&P/BARRA Value	614.8	1.6	-1.7	9.2
S&P Energy	306.7	4.2	6.3	35.0
S&P Financials	405.5	1.6	-1.4	3.2
S&P REIT	134.3	1.0	-7.0	10.0
S&P Transportation	221.5	0.7	-8.3	15.3
S&P Utilities	145.9	2.9	3.1	21.3
GSTI Internet	167.3	1.2	-6.2	13.8
PSE Technology	747.5	2.2	-4.1	2.0

*Mar. 19, 1999=1000 **Feb. 7, 2000=1000

GLOBAL MARKETS

	FEB. 2	WEEK	% CHANGE YEAR TO DATE
S&P Euro Plus (U.S. Dollar)	1366.1	1.3	-2
London (FT-SE 100)	4916.2	1.4	2
Paris (CAC 40)	3951.7	1.9	3
Frankfurt (DAX)	4296.3	2.0	0
Tokyo (NIKKEI 225)	11,407.1	0.3	-0
Hong Kong (Hang Seng)	13,555.8	-0.5	-4
Toronto (S&P/TSX Composite)	9303.9	1.5	0
Mexico City (IPC)	13,339.4	2.3	3

FUNDAMENTALS

	FEB. 1	WEEK AGO
S&P 500 Dividend Yield	1.93%	1.99%
S&P 500 P/E Ratio (Trailing 12 mos.)	19.6	19.5
S&P 500 P/E Ratio (Next 12 mos.)*	16.2	15.9
First Call Earnings Surprise*	4.19%	2.61%

TECHNICAL INDICATORS

	FEB. 1	WEEK AGO
S&P 500 200-day average	1135.0	1133.9
Stocks above 200-day average	74.0%	68.0%
Options: Put/call ratio	0.73	0.79
Insiders: Vickers NYSE Sell/buy ratio	4.52	5.09

BEST-PERFORMING GROUPS

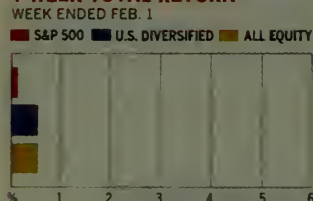
	LAST MONTH %	LAST 12 MONTHS %
Personal Products	13.4	80.4
Oil & Gas Refining	13.1	80.2
Drug Chains	11.7	70.9
Oil & Gas Exploration	7.6	52.1
Agricultural Products	7.4	51.2

WORST-PERFORMING GROUPS

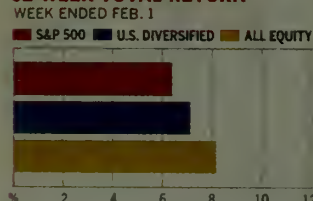
	LAST MONTH %	LAST 12 MONTHS %
Internet Retail	-32.2	IT Consulting
IT Consulting	-22.4	Electric Mfg. Svcs.
Application Software	-12.4	Insurance Brokers
Electric Mfg. Svcs.	-12.0	Semiconductor Equip
Airlines	-11.6	Semiconductors

MUTUAL FUNDS

4-WEEK TOTAL RETURN



52-WEEK TOTAL RETURN



Data: Standard & Poor's

EQUITY FUND CATEGORIES

4-WEEK TOTAL RETURN	%	52-WEEK TOTAL RETURN	%
LEADERS		LEADERS	
Natural Resources	7.4	Latin America	34.5
Latin America	4.8	Natural Resources	34.3
Utilities	3.2	Utilities	21.5
Diversified Emerg. Mkts.	3.0	Diversified Emerg. Mkts.	20.1
LAGGARDS		LAGGARDS	
Real Estate	-4.4	Technology	-7.3
Technology	-2.5	Precious Metals	-2.2
Communications	-1.7	Health	0.8
Large-cap Growth	-0.4	Large-cap Growth	2.5

EQUITY FUNDS

4-WEEK TOTAL RETURN	%	52-WEEK TOTAL RETURN	%
LEADERS		LEADERS	
ProFunds Oil & Gas Inv.	13.7	BlackRock Gl. Res. Inv. A	58.0
AIM Energy Investor	10.5	ProFunds Oil & Gas Inv.	54.2
CGM Capital Development	10.5	iShares MSCI Austria Idx.	50.6
T R. Price Em. Eur. & Mdn.	10.4	Metzler/Pdn. Eur. Em. Mkt.	49.5
LAGGARDS		LAGGARDS	
Apex Mid Cap Growth	-12.9	Ameritor Investment	-44.1
Amerindo Technology D	-10.9	ProFunds Semicdr. Inv.	-40.0
ProFds. Intnet. Ultsr. Inv.	-9.4	Van Wagoner Sm. Cap. Gr.	-30.8
American Heritage	-8.3	Apex Mid Cap Growth	-29.5

INTEREST RATES

KEY RATES

	FEB. 2	WEEK AGO
Money Market Funds	1.90%	1.85%
90-Day Treasury Bills	2.50	2.41
2-Year Treasury Notes	3.32	3.25
10-Year Treasury Notes	4.14	4.19
30-Year Treasury Bonds	4.58	4.66
30-Year Fixed Mortgage†	5.60	5.59

†Base

BLOOMBERG MUNI YIELD EQUIVALENTS

Taxable equivalent yields on AAA-rated, tax-exempt municipal bonds, assuming a 30% federal tax rate.

	10-YR. BOND	30
General Obligations	3.54	
Taxable Equivalent	5.06	
Insured Revenue Bonds	3.45	
Taxable Equivalent	5.23	

THE WEEK AHEAD

INSTALLMENT CREDIT Monday, Feb. 7, 3 p.m. EST »

Consumers probably added \$6 billion of new debt in December. That's the median forecast of economists surveyed by Action Economics LLC. In November, debt shrank by \$8.7 billion, as people cut back on revolving credit, made up largely of credit-card balances.

INTERNATIONAL TRADE

Thursday, Feb. 10, 8:30 a.m. EST » The December foreign

trade deficit probably totaled \$57.5 billion. Exports very likely improved, while imports probably fell. The November trade gap hit a record \$60.3 billion. But Statistics Canada has reported an error in its November trade data, suggesting that the U.S. deficit for that month will be revised lower.

INITIAL UNEMPLOYMENT CLAIMS

Thursday, Feb. 10, 8:30 a.m. EST » New filings for state unemployment claims most likely

totaled about 315,000 in the week ending Feb. 5, from 325,000 for the week ended Jan. 21.

FEDERAL BUDGET Thursday, Feb. 10, 2 p.m. EST »

The federal government will probably report a \$5 billion surplus for January, the fourth month of fiscal year 2005, after a \$3.4 billion shortfall in December. The Office of Management & Budget is forecasting a deficit of \$331 billion for all of fiscal 2005.

The *BusinessWeek* production rose to 240.8 for the week Jan. 22, a 12.8% increase from previous year. Before calculating the four-week moving average index slipped to 239.8.

BusinessWeek on

For the BW50, more investment data, and the components of the production index visit www.businessweek.com/magazine/

Fighting Cancer



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Last year around six million people died of cancer – equivalent to the population of Hong Kong or Rio de Janeiro.

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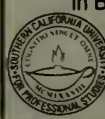
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Wanted: An Honest Budget

PRESIDENT BUSH IS about to announce his next federal budget. He will likely call for a freeze on discretionary spending at near-current levels. He will inform the public that the deficit, which ballooned in his first term, is shrinking, thanks to a strong economy that is generating higher revenues from taxes on income, corporate profits, capital gains, and dividends. And he will propose cutting the deficit in half in four years, in fiscal 2009. That's the good news.

Unfortunately, there will also be bad news. The President's budget won't include the cost of the Iraq occupation, the potential cost of making the transition to private Social Security accounts, or the cost of fixing the alternative minimum tax. These are significant omissions (page 30).

It gets worse. The President is sure to ask Congress to make permanent his previous tax cuts. At the same time he is proposing a five-year budget instead of the usual 10-year plan. That means most of the fiscal impact of his tax cuts won't be felt until he leaves office. And then it will be severe. If all the 2001 and 2002 tax cuts are made

permanent, the deficit will rise by an additional \$45 billion in 2009. In 2012, the hit to the deficit will grow to \$3 billion. President Bush may succeed in his goal of cutting the deficit in half by the end of his Administration, but he could easily leave behind a fiscal disaster that will drive interest rates higher and the dollar much lower.

What's missing? Costs for Iraq, Social Security reform, and fixing the AMT

Certainly, there are reasons to extend many of the tax cuts. Lower taxes on income and capital gains increase incentives for investment, and economic growth. There are good reasons to reform the alternative minimum tax, which increasingly punishes the middle class. There

are good reasons to fund Iraq's experiment in democracy as the U.S. draws down its military forces there. And there are even some reasons to promote private Social Security accounts. They prefund retirement and build a nest egg.

But there are no good reasons for hiding the cost of these endeavors or denying their consequences. New private retirement accounts could cost \$1.5 trillion from 2011 to 2015 and add \$100 billion a year to the budget deficit in years 16 through 20. Making tax cuts permanent could cost \$2 trillion. Fixing the AMT could cost an additional \$500 billion. These are real numbers that should be included in any real budget. If President Bush believes the policies proposed are in the best interest of the nation, then he should lead an honest dialogue about how we should pay for them.

CEOs Get Their Groove Back

ANIMAL SPIRITS are infusing Corporate America once again. After years of playing defense, chief executives are back in the game. Well-stocked with solid profits and cash, CEOs are starting to do deals, invest in technology, and take on more risk. While many executives complain that they are bogged down trying to comply with Sarbanes-Oxley legislation, others are busy building their businesses. 2005 is shaping up to be a year when foresighted CEOs begin to stake out claims on the future. Those who remain in a defensive crouch are in danger of being left behind.

Of course, the burgeoning merger-and-acquisition activity is also a chance to correct past mistakes. The financial supermarkets assembled in the '90s are being rethought. The brokerage, retail-banking, and insurance synergies that motivated Sanford I. Weill's dream for Citigroup, for example,

never panned out. Indeed, such synergies often led to a loss of interest. His successor, Charles Prince, is rewriting Citigroup's playbook by selling off Travelers Life & Annuity and Citicorp's international insurance business. Prince is focusing Citigroup on its core capital. Likewise, Kenneth I. Chenault, CEO of American Express Co., is spinning off American Express Financial Advisors to allocate capital to businesses with higher returns.

A.G. Lafley, on the other hand, is focusing Procter & Gamble Co. on innovation. P&G's CEO is creating a new paradigm, and his \$57 billion purchase of Gillette Co. is pushing him to expand it on a much larger global scale. By going beyond P&G for the first time for new products, bringing in outside design innovators to develop new ideas, and refurbishing tried-and-true products, Lafley is teaching Corporate America how to profit through high-value added innovation, not just cost reduction (page 26).

Then there are the consolidators. At long last, telecom is shedding its excess capacity in a series of huge deals. Sprint Communications Inc. CEO Edward E. Whitacre is paying \$11 billion for the venerable AT&T, making SBC America's largest telecom. This follows purchases of AT&T Wireless and Pacific Bell by Cingular, which SBC jointly owns with BellSouth Corp.

The surge in animal spirits must, of course, be tempered. Research shows that many mergers are ill-conceived and leave investors in the lurch. Yet many of the new deals appear to have logic on their side and reflect a fresh burst of energy in the economy.

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CAN ANYONE SAVE HP?

ELGIN (P.28)

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FAILED VISION

Fiorina believed HP should be a one-stop tech shop. The problem was that it just didn't work



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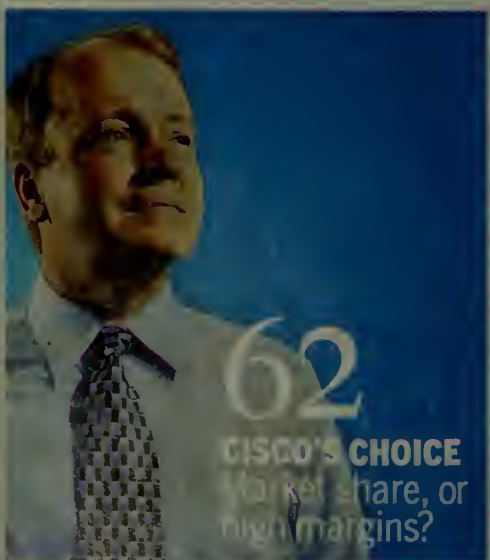
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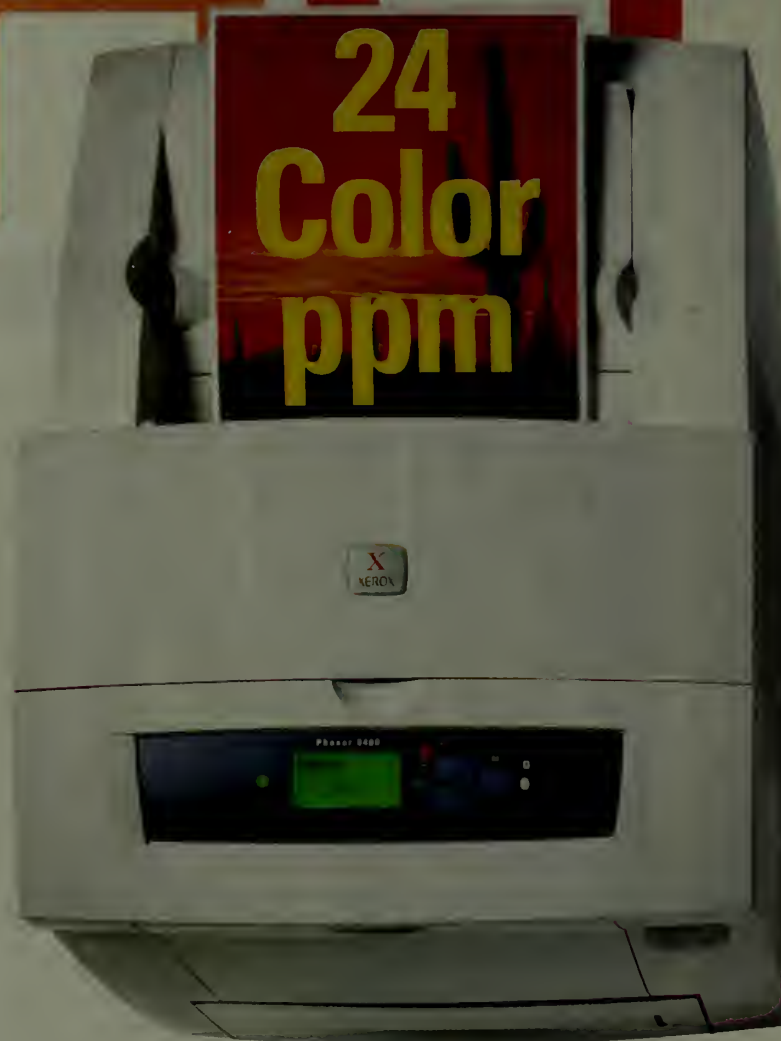
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Plasma-TV Makers: The Squeeze Is on

Fujitsu and other manufacturers are finding that competing in an era of falling big-screen prices may not be worth the fight, especially given the hot competition from LCD and projection technologies



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Star Wars Faces A 2006 Budget Hit

It's not just the technology's reliability problems that are prompting a funding cut. Equally significant is the changing nature of potential security threats since Bush took office in 2000



Britain's Universities Go Begging

The country's cash-strapped colleges are following the U.S. example and turning to alumni for fund-raising help. Only this time, the British schools aren't finding much success so far—and changing that won't be easy

David Wyss on the Dollar And the Trade Deficit

S&P's chief economist says the greenback will continue to decline, but unlike previous downtrends, it will be some time before the U.S. trade gap shrinks



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No. 2 again."

—Mel Karmazin, former
president of Viacom and now
CEO of Sirius Satellite Radio,
on what he learned working
over four years with Viacom
CEO Sumner Redstone

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on 17, Secretary of State
Condoleezza Rice said the
effort of training Iraq's
security forces—army, police,
national guard—falls to
partners: the U.S.,
France, NATO, Iraq, Jordan,
and others. But Rice and other
officials have yet to mention
the significant role being
played by private contractors.
More than 700
contractors—from companies
such as Science Applications



national,
corporate, and
U.S. State
investigations
agencies—are

training more than half the
Iraqi Police Service,
BusinessWeek has learned.
Contractors will account for
about 25% of Iraq's 275,000 total
security personnel. It's
unclear how much of the \$5
billion allocated for security
will go to private companies have
been awarded, but USIS' contract
with the Justice Dept., for one,
is worth over \$200 million.

—Spencer E. Ante

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Private
contracts
are fat

THE DEAL MILL

A Lemon For Lenovo?

LENOVO MIGHT have a rougher
time with its \$1.25 billion
acquisition of IBM's PC unit
than was at first apparent. In
addition to a just-ordered U.S.
government review of security
issues raised by the deal, there
are new signs of weakness in
IBM's PC business.

BusinessWeek has learned
that **General Electric** late last
year dropped IBM as one of its
two PC suppliers to go exclu-
sively with **Dell** for desktop
and notebook computers.
According to sources, GE
made the switch because of
Dell's lower prices. The compa-
nies declined to comment.

While there's no evidence
of mass customer defections,
since the deal was announced
on Dec. 7, IBM PC sales have
lost momentum—with
revenues for the Personal

Systems Division, which in-
cludes the PC unit, up just 2%
in the fourth quarter. Mean-
while, worldwide market
share for its ThinkPad note-
books fell to 8.2%
from 10% in the
second half of
2004, says mar-
ket researcher
IDC.

Then there's
IBM's pesky war-
ranty problem.
The failure of a
component in
desktop PCs sold
in 2003 pushed
up warranty costs for the first
two quarters of last year to
7% of PC revenues—well
above the industry's typical
5%, and more than twice
Dell's level. The problem cost
IBM 6.1% of PC revenues in

2003. To cover future
liabilities, IBM will pay the
Chinese company up to \$100
million, according to a
Lenovo filing with the Hong
Kong Stock Exchange. IBM
declined to disclose warranty
costs for the rest of 2004.

The news doesn't get
better. A yet-to-be-released
customer survey by **Technol-
ogy Business Research** shows
that while customer loyalty to
the ThinkPad line is strong,
desktop PCs fell from 4.0 to
3.6, on a scale of 1 to 5,
between the second and
fourth quarters. "The Lenovo

deal may be
hurting them,"
says TBR analyst
Julie Perron.

IBM and
Lenovo say
they're working
with the govern-
ment and expect
to close the deal.
IBM says that in
a survey of 4,000
customers, more

than 90% favor the deal. It
says the warranty problems
are over and plans to air
ThinkPad TV ads in late
February to bolster the brand.

—Steve Hamm, with Andrew
Park and Ben Elgin

THINKPAD
Dumped
for Dell?

60%

The portion of
IBM's \$10.6
billion PC
business from
notebook sales

Data: Merrill Lynch

GLAZINGS IS GOLDMAN CAUGHT IN A DONUT HOLE?

IS GOLDMAN SACHS fishing near the bottom? On Feb. 7 the investment bank reported in an SEC filing that as of Dec. 31, it owns a 5.8% stake in **Krispy Kreme Doughnuts**. Goldman may be betting on a rebound for the troubled donut maker. But Krispy



Kreme's shares have tumbled nearly 40% in the new year, turning a \$45 million stake into about \$28.5 million.

Indeed, things have gone from bad to worse for Krispy Kreme. The stock is currently worth a quarter of its value in 2003. And amid an **SEC** investigation into recent franchise buybacks, the company announced it will restate earnings for the last three quarters of 2004 and lay off 25% of its workforce. Krispy Kreme did not return calls, and Goldman declined to comment.

Perhaps Goldman, now the second-largest Krispy Kreme shareholder, sees potential in Stephen Cooper, who led **Enron** out of bankruptcy in 2004 and replaced company veteran Scott Livengood as CEO last month. Cooper has to live up to a lot of potential before Goldman's stake is back in the black. —Erin Chambers



SOFTWARE HARBALL

SOUR NOTES Few of Microsoft's battles are more pitched than the struggle to rule digital music. So far, it's getting pummeled by Apple Computer and its popular iPod. No wonder Microsoft execs get a bit peeved when they see those telltale white cords hanging from ears at the Redmond (Wash.) campus. The iPod is popular enough at Microsoft that one worker sent an e-mail to colleagues notifying them about new shipments to a nearby Apple store. That drew a sharp riposte from Dave Fester, general manager of the Windows Media division. "I sure hope Microsoft employees are not buying iPods," he wrote. "We have great alternative software. Evidently not good enough." —Jay Green

TAKING A PASS HOCKEY FANS HAVE GONE INTO HIDING

WITH THE National Hockey League locked out, the **American Hockey League**, the top minor league, figured to get a lift. That hasn't happened—at least, not in the U.S. As of Jan. 31, the AHL posted a puny 2.8% gain in ticket sales over last season. Crowds have shrunk for 13 of 28 teams.

But three of its four teams in Canada are up. The Road Runners, having relocated from Toronto to Edmonton, have seen ticket sales rise a league-best 85%, to an average of 8,492, and the Manitoba Moose sell 96% of seats. It's the national game, after all. —Mark Hyman

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FACE TIME

LESTER WUNDERMAN



GO AHEAD, HANG UP ON THIS MAN

Don't get Lester Wunderman started on the topic of junk mail. Wunderman, the 84-year-old father of direct marketing and founder of the global communications giant that bears his name, winces at the term. "We get picked on," says the man behind such innovations as the Gevalia Kaffee coffee-of-the-month and Columbia House monthly music marketers.

Despite spam blockers, a National Do Not Call Registry, and other measures to stop unwanted intrusions, one-to-one marketing is growing faster than other forms of ads. Why? The Web and other technologies have made it easier to measure such strategies and hone targets. "Now you're advertising to people you know something about," he says.

Wunderman doesn't mind people blocking e-mails or ignoring telemarketing calls during supper. With one-to-one marketing, he argues, people are more peeved when they get the wrong pitch. But the right one, he says, is more likely to pay off.

—Diane Brady

BROADCAST NEWS

SPIKE TV'S FEMININE SIDE?

ALBIE HECHT'S sudden resignation on Jan. 31 as president of cable network **Spike TV** was blamed on creative differences. Apparently, those creative differences caused female viewers to, well, spike. And that's a problem for a network that has built its brand—and advertising base—around programming for men.

When the men's cable channel launched in August, 2003, 68% of viewers were guys, giving Spike one of TV's largest percentages of male watchers. By the end of 2004 male viewers had fallen to 58%, and women had jumped to 42%. The network blames reruns of crime show *CSI: Crime Scene Investigation*, which brought in predominantly female viewers when it first aired on CBS. *CSI* started airing nightly on Spike last September and contributed to a 10% ratings boost among men. But the



CSI Women love the show—and advertisers are dismayed

gain in female viewers is reason for concern at

the network, says Andy Donchin, who directs national broadcast for media buyer **Carat USA**. "We're buying [the advertising] off of male guarantees," he says.

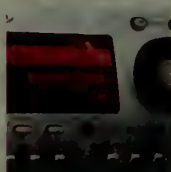
Spike, owned by **MTV Networks**, remains one of the few cable channels other than **ESPN** able to capture the elusive, and coveted, young

male audience. To maintain its ratings bump without attracting the wrong crowd, media experts say, Spike needs a hit original show. That puts the pressure on Hecht's replacement, Don Herzog, who developed cartoon hit *South Park* for **Comedy Central**, to deliver another winner. "In a perfect world, that hit will have a 80/20 male/female balance," says Herzog. Here's hoping it doesn't strike a chord with women. —Jessi Hempel

MEDIA MOVES

DIGITAL DIVIDE On Feb. 2, News Corp. announced that its second-quarter profits jumped 80%, to \$386 million, on red-hot sales of DVDs. That underscores the emerging preeminence of digital technologies to media companies' bottom lines. Here's how consumer spending on several media categories—old and new—is expected to take shape in the next five years:

COMPOUND ANNUAL SPENDING GROWTH RATE*



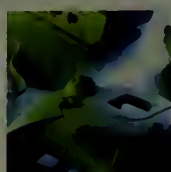
SATELLITE RADIO

84.9%



HOME VIDEO

10.8%



VIDEO GAMES

9.6%



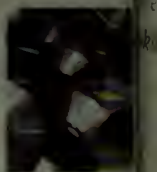
CABLE AND SATELLITE TV

6.4%



CONSUMER MAGAZINES

0.6%



RECORDED MUSIC

-0.9%

Data: Source: NPD Group, Inc. *Projected 2003-08

ART.

A LANGUAGE THE WORLD UNDERSTANDS.



Pskovo-Pechersky Monastery VLADIMIR F. STOZHAROV 1972

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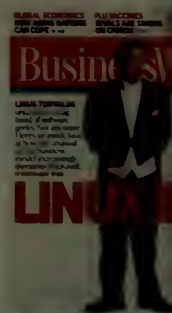
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I keep hearing that Linux is more suitable for specialists ... [but] I was able to convert ... quite painlessly."

—Gary Layng
Toronto



MORE FANS LINE UP FOR LINUX —OR IS THAT GNU/LINUX?

I'VE USED LINUX ON my home computer ever since a spectacularly disastrous "upgrade" to Windows XP in the fall of 2003 ("Linux Inc.," Cover Story, Jan. 31). I keep hearing that Linux is more suitable for specialists than for ordinary desktop office users and that there will be incredible training costs. I was able to convert from Microsoft Office to OpenOffice quite painlessly with just a bit of hunting for MS Office command equivalents. My father, 75, was able to access his e-mail on my computer without any problems and without having used Linux before.

Yes, Microsoft should worry: Someone has come up with a far more stable, secure operating platform with a decent range of quality office-productivity tools at a licensing price far below anything Microsoft can hope to match profitably.

—Gary Layng
Toronto

STEVE HAMM'S "LINUX INC." was not entirely accurate in what it said about me. I criticize Linus Torvalds for publicly and visibly using a nonfree program to develop Linux, but I do not refuse to speak to him.

Tie-wearing officials and even some nescpeople continue to talk with mostly outside the U.S. The article mentioned St. IGNUcius without identifying him as a comedy routine—since oil tractors sometimes call free software St. IGNUcius turns this around as a joke.

More fundamentally, the article reveals a common confusion when it speaks of Linux as an operating system. The article explained the system's origin—how Linus Torvalds' Linux kernel filled the gap in nearly complete GNU operating system and the GNU/Linux combination is a system that people use. But then it regarded this and went on to use the term Linux indiscriminately, both for Torvalds' part and for the whole system. This creates a confusion that takes an expert to straighten out.

History shows that people who value freedom are apt to lose it. Most operating systems were developed for commercial or technical reasons; GNU/Linux is the only one gaining in popularity, in part for freedom and community. When we use free software, we are free to modify the software do what you wish—on our own, by hiring someone, by working

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RECTIONS & CLARIFICATIONS

I believe the hype" (Personal Business,) refers to NF Communications, a company that sells training programs to annuity salespeople how to find potential seniors who might want to buy or lease an annuity. President Larry Klein of the program advises salespeople not to engage in exchanges unless it is to the salesperson's advantage.

a whole new playbook" (Finance, Feb.) could have said that expense growth exceeded revenue growth in seven of our company's nine units.

ed way out of AOL" (UpFront, Feb. 14) recently ran a photo of former AOL employee J. Michael Kelly instead of David J. Arn, ex-president of AOL's business unit.

users, or doing all three. When Linux users know its history—how the result of a campaign for free software may lead them to value freedom.

—Richard Stallman, President
Free Software Foundation
Cambridge, Mass.

RESEARCH INTO the evolution of the Linux ecosystem over the past five years, based on the support of third-party independent software vendors, reinforces our chart "Where Linux is going." In a market setting, the acceptance of Linux on desktops is dictated by the growth of third-party applications. The ecosystem supporting Linux exclusively is growing, so Microsoft's position may shift. The trends of third-party application providers should be mapped to the seven stages of "How Linux works" to fully understand its future.

—N. Venkat Venkatraman
Bala Lyyer
Chi-Hyon Lee
MIT Sloan University School of Management
Boston

TATE CLEARS UP THE TANGLED LINES

OF MY COMMENTS were misquoted in "We're not a phone company" (Information Technology, Jan. 31). Allstate has no plans to turn over its computer security to anyone. We consider our computer, employee, and agent computer security inviolable and will always maintain control over it. However, we appreciate the security tools MCI Inc. has built into its network system that provide a first

line of defense in our security approach. For the record, Allstate has not decided to "tear out all its old analog lines by 2007." Our strategy is to move to voice over IP, but we will do that judiciously based on several factors, including lease expirations and new business opportunities. The 3% savings referenced in your article would be typical in greenfield locations and not a total savings across the enterprise.

—Cathy Brune
Allstate Insurance Co.
Northbrook, Ill.

THE CHAMBER WANTS CLASS ACTIONS IN FEDERAL COURT

CLASS ACTIONS involving thousands (and sometimes millions) of citizens from many states belong in federal court ("A phony cure," News: Analysis & Commentary, Feb. 7). Such lawsuits typically involve more people, more money, and more national policy ramifications than any other kind of litigation. Such national cases should not be handled exclusively by county court judges elected by—and accountable only to—the few thousand people in one particular community. The federal Judicial Conference has stated that allowing more interstate class actions into our federal courts would stop the serious class action abuses occurring in state courts.

The suggestion that state courts have more time for these gigantic cases is dead wrong. The average state court judge is annually assigned three times as many cases as his/her federal counterparts.

—Stanton D. Anderson
U.S. Chamber of Commerce
Washington

Editor's Note: The writer, a partner in the law firm McDermott, Will & Emery, chairs the Chamber's Class Action Fairness Coalition.

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Up from Stove Black

THE GUGGENHEIMS A Family History

By Irwin Unger and Debi Unger; HarperCollins: 550pp; \$29.95

He started out like hundreds of other mid-1800s immigrants to the U.S., hawking wares from a wagon in Philadelphia and in nearby towns. A big seller was stove black, used to cover up scrapes and rust on cast-iron furnaces. Before long he devised his own, less messy formula—composed of black lead

mixed with soap—and he and his father began producing the stuff in quantity, using a converted sausage machine to extrude it into paper packets. The experience provided Meyer Guggenheim with the principles that informed the remainder of his life: better to produce than merely sell, better to keep everything in the family.

Paterfamilias Meyer is a towering figure in Irwin and Debi Unger's *The Guggenheims: A Family History*, an exhaustive, richly developed portrait of the rise and decline of one of America's best-known clans. While the book is light on social context, it offers insight into the mores and lifestyle of the Gilded Age. To the Ungers, Meyer was the lone genius behind the family's colossal success. A "driving, acquisitive man," short, with muttonchop whiskers, he was determined to "position his sons as rich men for life." He did that so well that five generations have lived largely off his wealth. By the mid-1920s, his heirs could claim to be the second-richest Jewish family in the world, after the Rothschilds.

Meyer spent his life doing deals. In 1880, using stock-market gains and earnings from an embroidery business, he bought two flooded mines in Leadville, Colo., which ultimately yielded 50 tons of silver and lead a day—worth nearly \$1 million a day in current dollars. His Midas touch established, Meyer turned his attention to what became the family's core property, ARASCO, a copper-mining and smelting syndicate with holdings across the Western U.S., Chile, Bolivia, and Canada. But he didn't lunge for the deal. He waited until 1900, when ARASCO's cash-strapped investors begged him to take a majority interest. In the decades that followed, his seven sons built on the business, expanding into tin and nitrates for fertilizer. When electrification spread throughout America, the price of copper soared, and the Guggenheims were major beneficiaries.

The family became charter members of New York's elite Our Crowd society and were much at ease in European salons. A high-profile way of life made them social headlines even as their ancestry and great wealth made them targets for the yellow press, where Meyer was depicted as an "unscrupulous

Jewish businessman" and his sons were called war profiteers. Despite such anti-Semitic slanders, the Guggenheims were particularly identifiable as Jews: Religion was not a major focus of their attention. They lavished money on the arts and education but gave little to Jewish causes. One daughter was shocked to learn from her nanny that she was a Jew.

While the Guggenheims were tremendously successful, their name is hardly ubiquitous, partly because of the paucity of male heirs. Not that there was a shortage of romance: There were often multiple mates and multiple liaisons. Grandfather Harold Loeb Jr. had five wives. Granddaughter Peggy, whose passions were "art and lovers," encouraged her teenage daughter Pegeen to "engage in sexual escapades." Pegeen bunked on Errol Flynn's yacht and moved in with an Acapulco cliff diver. It was a far cry from Meyer's vision of cohesive family managing and expanding the fortune through successive generations.

There is a Guggenheim heritage—it's just more diffuse than that of many other wealthy families. The Guggenheims had a wide range of interests. Meyer's son Simon, for example, used his wealth to buy a Senate seat from Colorado but soon became bored with Washington and returned to business. Harold became the publisher of a 1920s Paris literary magazine, *Broom*—and the model for social-climbing Robert Cohn in Ernest Hemingway's *The Sun Also Rises*. Another grandson, Harry, spent freely to promote civilian aviation. Cornelia Love, a fourth-generation family member, became a noted archaeologist. The Guggenheims supported the arts, and their patronage lives on

New York's Solomon R. Guggenheim Museum and affiliates in Venice, Berlin, Vegas, and Bilbao, Spain. The family made a mark in publishing, too, owning *Nation* and several magazines, and founding book publisher Farrar, Straus & Giroux.

Lacking a broader framework, *The Guggenheims* tends to flounder in the last

Five generations have lived largely off one titan's wealth

third, where readers meet dozens of semi-idle Guggenheim whom they're unlikely to care about. And unlike previous works by the Ungers—such as Irwin's *The Greenback Era*, which delivered a social critique of late-19th century America—issues of immigrant struggle, class warfare, and even the preservation of great wealth through an era of confiscatory estate taxes aren't addressed. Perhaps the authors became exhausted by the scope of their project. Or, again, maybe they were satisfied simply to tell a great tale

—By Bob De



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BY STEPHEN H. WILDSTROM

Laptop Batteries That Last All Day?

If you aren't into photo editing or ripping music, and your laptop is less than two years old, your machine may not strike you as too slow. But even if you have yet to plunge into graphics, demands on your system are rising with pictures in e-mail, video on Web sites, and programs that monitor the state of your PC. Intel has no choice but to make faster hardware.

The company recognized several years ago that its strategy of boosting performance by making mobile chips run faster was taking too great a toll on battery life. The answer, first offered in 2003, was the Pentium M (branded as Centrino when coupled with an Intel Wi-Fi network adapter). The Pentium M had a slower clock speed, or megahertz rating, than the chip it replaced. But it greatly enhanced performance in other ways, such as fetching instructions and data more efficiently.

The newest version of the Pentium M, code-named Sonoma, takes this a step further. Initial versions of the processor keep the maximum clock speed essentially unchanged, at a little more than 2 gigahertz. Instead, performance is boosted by dramatically increasing the speed at which the processor communicates with other components. There's a 33% bump in the speed at which data move between processor and memory. And a technology called PCI Express allows video to be pumped to graphics adapters at much higher speeds. The result is a considerable narrowing of the gap between laptop and desktop performance. This does come at some cost in battery life, however, with most manufacturers reporting a decline of 20 to 30 minutes of running time on similar models.

THE NEWEST PENTIUM M CHIPS ARE SHOWING up in a broad range of laptops. I had a chance to try three of them, and in general, I'm impressed. The Gateway M460E is a low-end Sonoma consumer notebook that crams a lot of value into a \$999 package, including a 15-in. display. Other models come with a 15.4-in. wide-screen display. At about 6 lb., you wouldn't want to carry the M460 every day, but it's reasonably mobile.

The IBM ThinkPad T43, starting at about \$1,500, is the Sonoma version of a thin, light corporate workhorse. It's just an inch thick, weighs around 5 lb., and comes with a 14.1-in. or 15-in. display.

The Dell Latitude D410, starting at \$1,677, is the lightest of

DELL
LATITUDE
D410
LAPTOP



this trio and has the longest battery life. Aimed at mobile executives, it weighs just 3.8 lb., and the battery lasts about seven hours. But you have to make do with a 12.1-in. display and no built-in DVD drive. To get those extra hours, the D410 uses a much higher-capacity battery than its predecessor.

Sonoma processors will power most notebooks this year. The main challenge comes this summer from an Advanced Micro Devices chip called Turion, designed to match Pentium M's efficiency. Don't expect much new in notebook designs, though manufacturers usually make big changes only when Intel introduces a new processor.

The really big news in chips won't be out until 2006

The next big wave of change will come in 2006, when Intel breaks away from the decade-old mobile Pentium tradition. Its next chip, code-named Yonah, will have two processors in a single package. That should be a big advantage, since two relatively slow processors can perform better while consuming

less power than can a single, faster one. Software can further boost efficiency by using just one processor for some tasks.

The transition to these so-called dual-core chips should be fairly slow because a version of Windows that takes full advantage of the technology isn't expected until late 2006. But it should be a big deal. Centrino led to a generation of speedy, lightweight notebooks that eliminated the network cable and allowed a long time away from the electrical outlet. If Yonah delivers, we'll finally have notebooks that run all day on a single battery charge. ■

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BY LAURA D'ANDREA TYSON

How Europe Is Revving Its Engine

The European Union recently announced a five-year agenda that is unabashedly pro-business—with a focus on growth, job creation, and technological innovation. José Manuel Barroso, the new, young president of the European Commission, was previously Prime Minister of Portugal, one of Europe's success stories. His zeal for fostering employment and

a business-friendly environment is genuine. Under his leadership, the EC has pledged to subject all new regulatory initiatives to a tough competitiveness test before they are approved. After a decade of disappointing economic performance, is Europe poised for a sustained rebound? There are reasons to think so.

In fact, Europe's recent performance has not been nearly as dismal as many observers suppose. Excluding the 10 new members—primarily former Soviet-bloc nations that joined the EU in May, 2004—output per hour worked in the EU is only slightly lower than in the U.S. According to a Conference Board study, productivity growth in the U.S. between 1995 and 2004 was one percentage point greater than in the EU (2.5% a year vs. 1.5%). But Austria, France, and Sweden were not far behind.

TO SOME EXTENT, European productivity growth has been the victim of the moderate success of another EU policy goal: increasing the employment participation rate. Since the EU population is growing at only about 0.2% per annum, economic growth hinges on providing jobs for the working-age population. EU employment participation has increased at 0.5% a year over the past decade, with most of the growth occurring in the past five years. In contrast, the U.S. rate has been falling at 1.2% per annum since 2000 in response to weak labor demand.

Labor-market reforms are promoting both labor-force participation and enhanced flexibility in the EU. Germany has introduced reforms that ease dismissal protection for workers and encourage the unemployed and low-skilled workers to take new jobs. In the short run, these reforms are likely to increase the unemployment rate in Germany. In January the number of unemployed topped 5 million, the highest figure in more than 50 years. But in the long run, such reforms are essential to reducing labor costs and labor-market rigidities. France is loosening some of the restrictions on working more than 35 hours per week and promoting youth employment through training and apprenticeships. Both temporary and part-time workers are growing as a share of total employment throughout the EU.

The enlargement of the EU to include 10 new members with lower labor costs is propelling changes within the richer

nations. Several big German corporations have used credible threats of outsourcing work or moving production facilities to the new EU countries to win benefit cuts and an extension of working hours without additional compensation.

Many European companies have made massive investments in information and communications technologies (ICT) in recent years and are completing corporate restructuring plans to maximize returns on these investments. The strength of the euro is compelling European firms to focus on productivity while reducing the cost of additional investments in ICT equipment. As a result, Morgan Stanley economists are predicting that Europe may be at the beginning of a productivity revival like the one the U.S. has enjoyed from an earlier boom in ICT investment.

A tough new economic agenda is aimed at boosting productivity

The most important thing the new European Commission can do is to foster increased productivity to accelerate product market deregulation, especially in such sectors as telecom, financial services, retail, and business services. In the U.S., the most dramatic productivity gains from the ICT revolution have been realized in these intensive ICT-using services. But Europe still suffers from national regulatory

regimes that pose barriers to the expansion of existing plants and to the entry of new ones in the services sector. These barriers lie behind a jarring dichotomy in the EU between a modern, often highly competitive industrial sector and an underdeveloped, sometimes antiquated service sector.

In the past five years the EU has successfully absorbed 15 member states and introduced the euro, which in turn bolsters intra-European trade and financial market integration. Now there are promising signs that Europe may be on the verge of secular improvement in employment and productivity growth. That would be great news for the world economy. ■

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JAMES C. COOPER & KATHLEEN MADIGAN

Job Growth Will Get Over Its January Blahs

Weather helped cause a weak start to what will be a solid year

U.S. ECONOMY The economy this year was expected to generate job gains of 200,000 or more a month, with accompanying rises in incomes and consumer confidence. But this trip to bountiful took a turn in January, when nonfarm businesses added only 146,000 new workers and wage growth was lackluster. But before you write off the

outlook, bear in mind that the January job report may be saying more about the weather and the vestiges of last year's autumn spike in oil prices than about the health of the economy. Clear away the rain, snow, and ice, and a picture of growth comes into focus.

More fundamentally, the slowdown in productivity growth, coming at a time when overall demand is still strong, tells us that last year's acceleration in job growth, with gains averaging 181,000 per month, has staying power. After three years of boosting production of goods and services solely with increases in productivity, companies have squeezed about all of the output gains out of their existing payrolls. In classic business-cycle form, the economy last year entered the stage where it is better balanced between gains generated by productivity growth and those coming from new workers. It is also important to remember that this expansion has been the most unusual in the modern era for both employment growth and productivity. Job gains have been the weakest, and productivity has been the strongest. One implication is that productivity is unlikely to return to the low rates of growth reached in past economic expansions (chart).

Why? Companies still face the competitive imperative to boost productivity. And while they are still reaping efficiency gains from past investments in new technologies, they are also now boosting their rate of investment in new equipment.

The other implication is that job growth this year, the first year of expansion, will not match past standards. For example, in the fourth year after the 1990-91 recession, job growth averaged 306,000 per month. That is a pipe dream for 2005. But given the expected pace in the economy and the slowdown in productivity this year, job gains can still hit the 200,000 monthly rate and boost household income.

JANUARY RISE in payrolls seems to understate the trend in job growth. Unusually harsh weather may have held down the totals. The Labor Dept.'s data on the reasons people miss work show that 305,000 in nonfarm industries said they couldn't get to work last month because of weather. That number was the most in any

January since 1999, and the increase from December to January in the number reporting that circumstance was also the largest since 1999. More normal weather in February could result in a sizable rebound in payrolls.

Weather effects can also be seen in the industry data. Construction employment dropped by 9,000 jobs last month, after gains averaging 25,000 per month from

October through December. The construction workweek fell by 48 minutes, the second-largest drop in the past seven years. If payrolls in February fully return to their recent trend, construction, by itself, would add more than 30,000 jobs.

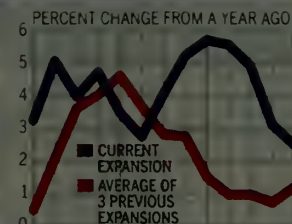
Plus, factory payrolls shrank by 25,000, after losses had appeared to

stabilize. The drop was the biggest in more than a year and runs counter to recent strong data on new factory orders, industrial production, and from the nation's purchasing managers. Payrolls in the auto industry alone fell by a large 10,000, suggesting that holiday shutdowns may have distorted the data.

OTHER TRENDS point to better job growth ahead. First, weekly claims for unemployment insurance remain at low levels. Their four-week average in recent weeks has dipped below the 340,000 per week averaged during the past six months. The relationship between claims and job gains since 1990 says that claims, at 340,000, are consistent with hiring of about 190,000 per month.

Second, and more important, job expansion will benefit from the waning growth of productivity. Output per hour worked in the fourth quarter grew at an annual rate of only 0.8% from the third quarter, the smallest quarterly increase in nearly four years. That slowdown is not alarming. Typically, productivity surges in the early stage of a recovery as companies lift their output faster than they add back laid-off workers. Later, productivity slows

PRODUCTIVITY'S UNUSUAL PERFORMANCE



Data: Labor Dept., Global Insight Inc., BW

as the recovery becomes established and businesses feel more confident about taking on new workers.

This time, the slippage in productivity growth began from an historically high level. The four-quarter pace peaked at a 30-year high of 5.7% in 2003. In the past three recoveries, the average falloff in growth was 3.9 percentage points. If productivity growth slows by that much this time, the rate would hit a low of only 1.7%. In some past expansions, the pace had dipped below zero.

Given that the economy is expected to grow 3.5% in 2005, productivity growth of 1.7% means output gains would be about evenly divided between increased productivity and more jobs. A 1.7% pace of job growth would be equivalent to about 2.4 million jobs, or 200,000 slots per month. What would that mean for the economy? Well, job gains averaged 181,000 per month in 2004, allowing wage and salary income to grow 5%, and the jobless rate fell from 5.7% to 5.2% over the past year.

THE DECLINE IN the unemployment rate in 2005 may be more gradual, mainly because the data may be missing some of the slack in the labor markets. Much of the drop in the jobless rate last year reflected a decline in the share of the population with a job or looking for work.

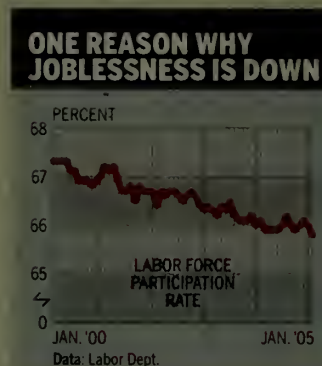
The labor force participation rate has fallen from 67.3% in early 2000 to 65.8% in January, the lowest in more than 16 years (chart). Had that rate not dipped as much, the jobless rate would be much higher. People may be dropping out of the labor force because they perceive what the numbers confirm: Today's job growth

does not match the more robust pace of past recovery.

On the plus side, much of the drop in participation occurred among teenagers, who appear to be seeking schooling instead of a job. The latest available data shows that school enrollments in 2003 were at an exceptionally high level. As people finish their degrees or learn new

skills, they will reenter the workforce, adding to the pool of available workers. That's why labor markets will be slow to tighten up.

As a result, pay growth, though picking up, will remain modest. Hourly wages grew only 0.2% last month, and they are up only 2.6% from the year before. That pace is better than the 1.6%



reached in February, 2004, but it is still well below the 4% or so clip seen during the late 1990s, when the unemployment rate fell below 4.5%.

Given the undercounted slack in the labor market and the structural downshift in hiring, a jobless rate at around 4.5% looks to be a 2006 goal. But that doesn't mean that 2005 labor markets will be a disappointment. Despite a slow January start, payrolls should post their best gain since 1999 and generate solid income growth for consumers, which will keep demand on the upswing.

GERMANY

For Consumers, Still Little Relief

GERMAN MANUFACTURERS are getting busier as demand picks up at home and abroad. But the revival in industrial activity is unlikely to do much for the labor market or consumer spending, leaving the economy to hobble along again this year.

After surges in oil prices and the euro led to a slowdown in the second half of 2004, demand appears to be coming back. In December industrial production increased by 1.2%, while factory orders swelled by 7.1%. New orders from abroad rose 5.3%. At the same time, domestic orders surged by 8.8%. The gains may be an early sign that German companies are taking part in the global

upswing in capital investment.

But companies remain hesitant to add workers, especially in higher-paying industries. In January, unemployment rose by 227,000. A big reason for the jump was a change in labor laws at the start of 2005 that pushes unemployed persons who weren't looking for jobs—and therefore weren't counted—to start looking if they are able to work. Even

excluding that shift, the labor market is weak, and chances of a drastic improvement anytime soon appear slim. The number of available jobs did rise by 16,000 in January, but many new positions are of the low-wage variety.

Those who are employed are unlikely to see their pay rise

substantially. In 2004, German employers clamped down on wage and extracted greater work time flexibility and other concessions from workers, and they are expected to do more of the same this year. Commerzbank expects wage settlements will yield raises of 1.5% to 2.5%, along with concessions in bonus and overtime pay. Overall, compensation gains may barely outpace inflation, currently running at a yearly pace of 1.7%.

Adjustments in the labor market should help German businesses become more competitive and, over time, help produce more jobs. But short-term pain will be borne by households. Indeed, January retail sales were down 0.3%, the third decline in four months. For that reason, economic growth will remain unbalanced and among the weakest in the euro zone over 2005.

—By James Mehring in New York

MANUFACTURERS ARE GETTING BUSIER



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CELEBRITY CEO
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any turnaround

CAN ANYONE SAVE HP?

Despite the board's insistence that it will stay the Carly course, a breakup may be the only way to turn the company around.

BY BEN ELGIN

Carleton S. Fiorina's last stand at Hewlett-Packard Co. took place, aptly enough, at an airport hotel. For six years the jet-setting CEO had flown the globe, smiling and perfectly coiffed even as she stepped off of red-eye flights. Jet never slowed down her delivery or muddled message, which described the sprawling HP as nothing less than the beating heart of the tech industry. Yet on a damp Sunday evening in

Chicago, as much of the nation focused on the Super Bowl, the 50-year-old Fiorina was embroiled in urgent talks with her board at a conference room at the O'Hare Hyatt, says an HP insider. The next day, Feb. 7, she was fired.

Thus ends the stormy reign of the highest-ranking woman in Corporate America and one of the boldest gamblers in the tech world. Fiorina pulled out all the stops as she hitched her soaring ambition to Silicon Valley's most venerable icon.

Not content to battle just one tech giant or two,

What Happens To the One-Stop Shop Carly Left Behind?

Fiorina positioned HP as perhaps the widest-ranging tech company in the world, with offerings from digital cameras to supercomputers. If her successor opts to narrow the focus, these divisions are candidates for spin-offs.

Data:



she took on a whole stable of them, from IBM and Dell to Sony and EMC. In the end, she failed. Outside of its stellar printing business, the \$80 billion HP she leaves behind is struggling in everything from PCs to software. The proud Fiorina departs as a humbled ex-CEO, but not a poor one: The board softened the blow with a \$21 million severance package.

The board, which named Chief Financial Officer Robert P. Wayman, a 36-year veteran, as interim CEO, is now searching for an exec ready and able to rescue HP. The crucial question for the next leader: Should HP remain intact? For months a number of Wall Street analysts have pushed for a breakup, arguing that HP's pieces, from the dynamic printer division to the lagging computer businesses, would be worth far more apart.

Fiorina fiercely resisted the calls, and the board supported her. But following the Feb. 9 announcement of her departure, investors bid up HP stock by 7%, to \$21.53, in part because of the possibility of a change in course. "We believe the long term probability of a breakup of the company is rising despite indications from the board that no such move is currently planned," wrote analyst Steven

Milunovich of Merrill Lynch & Co. in a report that day.

The forces for a breakup may grow by the time Fiorina's successor takes over. The logic is straightforward: HP may simply be trying to do too much. The giant lacks both the resources and management skills to compete with the best of the best in nearly every industry in tech. And investors aren't likely to wait patiently for a gradual turnaround.

SHOCK, THEN A PARTY

THE SIMPLEST CHOICE would be to spin off the corporate computing businesses, which are struggling against Dell and IBM, and force them to make the tough choices necessary to survive as independent entities. Then a trimmed-down HP could plow ahead as the world's leading printing and imaging company. No doubt analysts inside the company and out will be slicing HP into countless permutations over the coming months and feeding them into their computer models. "You want to organize your business around your customers, or at least around your markets," says Ted Schadler, a vice-president at Forrester Research Inc. "To do that, you want to split up your business."

At HP, where Fiorina was a deep divisive figure, news of her departure brought starkly different responses. The board stated its determination to stick with Fiorina's broad-based strategy, but some employees felt sorrow at her departure. For others, "it was a shock, then it was a party," says one. Then an e-mail went making the rounds: "Dingdong witch is dead."

Now HP's board is on the hunt for a replacement. They're looking for a CEO who can rescue HP, much the way Larry V. Gerstner Jr. lifted a troubled IBM from the sick bay when he arrived in 1993. The leading candidate, say insiders, is Inc. CEO Michael A. Capellas, who led Compaq Computer Corp. to Fiorina's hotly contested \$19 billion merger two years ago and briefly served as her No. 2.

Other possibilities include IBM's global-services chief, John Joyce, and Sun Microsystems Inc. CEO J. Zander, the former president of cell-phone giant Motorola Inc. Even the most talented exec will face an uphill battle trying to keep Fiorina's sprawling array of products together. "It's a Herculean task," says Jay



CORPORATE COMPUTING

company, printers account for HP's operating profits and the company's \$64 billion stock value. Some analysts have been calling for a spin-off, insisting its value is in HP's other tepid businesses. What's the plan? The next CEO sticks with it and sells the computer divisions.

Great at least for a couple of years. Dell is crashing into printers, threatening HP's margins. And HP is pouring billions into R&D to stay at the top of the pack.

Value: \$18 billion to \$22 billion

HP leads in storage and runs a strong second in servers. But profits and margins lag. Its corporate hardware businesses notched abysmal 1.1% operating margins in 2004. Services would likely be faring better if HP had bought PricewaterhouseCoopers three years ago. But HP balked at the price of the deal, allowing IBM to make the acquisition.

PROSPECTS HP will continue to be squeezed between Dell on the low end and IBM for the big corporate installations. HP desperately needs to bulk up its software business, a potentially profitable market.

VALUE \$18 billion to \$22 billion

PCS

Combining HP with Compaq created a giant—but not a profitable one. Dell is clobbering HP in PCs, with its lead stretching to 18.3% of the global market. That compares to a 15.7% stake for HP. It's margins hit a meager 0.9% in 2004, far below what the company projected when it merged with Compaq.

PROSPECTS Poor, as long as Dell is in the market and customers are focused on traditional computing. But with its blend of consumer electronics and imaging, HP is well positioned for the digital home market.

VALUE \$1 billion to \$3 billion

raith, a management consultant and author of *Building Organizations and the Global Customer*.

The question is whether the board's commitment to Fiorina's plan will survive the headhunting effort. The high-priced execs being considered may be too expensive to take on what has proven to be a difficult task, particularly if they set their own strategy. "If some execs get the sense that their hands are tied to be somewhat tied in making significant changes, that will limit the pool of possible candidates," says analyst Tony Ursillo of Morgan Stanley.

While a miracle turnaround can never be ruled out, the more likely scenario is an eventful breakup of HP. That would spell the end of an era. Ever since its founding in a Palo Alto garage 40 years ago, HP has represented the triumph of Silicon Valley special brand of entrepreneurialism that came to represent Silicon Valley. At its heart

it's an engineering-driven culture that values teamwork and rewards ideas and inventions, not pedigrees.

In truth, Fiorina was battling HP's storied culture from the day she arrived. A dynamic sales exec from Lucent Technologies, she was the first outsider to head the company. And she didn't hesitate to take out her hacksaw. Immediately, she began to reel in HP's 80-plus autonomous business units into a more centralized, four-divisions giant. She eventually laid off tens of thousands of workers.

Battling decades-old inertia, Fiorina began to centrally manage tasks such as branding and advertising. Even her critics say that these steps were needed, and that she fought some important battles to streamline HP's organization. "Carly recognized the need to

start leveraging the common strengths of the company," says Bojana Fazarinc, HP's former director of marketing services and branding, who is now an independent consultant.

She was decisive, no doubt about that, and a gifted communicator. But even early in her reign at HP, she began to demonstrate the weaknesses that would lead to her fall. First, she fired or scared away execs in droves, including such prominent figures as Antonio Perez, now president of Eastman Kodak, and Mary McDowell, now a senior executive at Nokia. She also resisted changing course—a dangerous trait in an industry in which the most successful leaders have been those who don't fall in love with their strategies.

Throughout her tenure, say insiders, she continued to blame HP's woes on the company's culture—not on severe management shortcomings, including her own. "She didn't develop enough effective lieutenants," says Stephen P. Mader, vice-chairman of Christian & Timbers, the headhunting firm that recruited Fiorina into HP. "Twice she passed up...opportunities to have a chief operating officer. Looks like it bit her."

The Compaq merger was the defining



DECEMBER 2004

The drumbeat from Wall Street was getting louder

Who's Next On the Hot Seat?

HP is looking for a top-notch operations executive to succeed Fiorina as CEO. Here are some of the likely candidates:



MICHAEL CAPELLAS

MCI's CEO ran Compaq for three years before its merger with HP. Capellas, 50, knows HP well and excels at building morale and improving execution—just what's needed. He's tied up with the MCI turnaround attempt. But if it's acquired, he'll be available.



VYOMESH "VJ" JOSHI

The 50-year-old executive vice-president of HP's huge imaging and printing division just had PCs added to his list of responsibilities. He has to be considered the top inside candidate because imaging and printing supplies three-quarters of HP's profits.



EDWARD ZANDER

He has been CEO of Motorola for only 13 months, but already he has impressed analysts with his strategy and results. Would the former Sun Microsystems COO leave Moto so soon? Maybe. The 58-year-old kept his home in sunny California.



JOHN JOYCE

Formerly IBM's CFO, the 51-year-old now runs the company's \$46 billion global services unit. He has a strong operations background—as a controller for IBM's global operations and as head of its internal reengineering projects in the mid-1990s.

moment in Fiorina's reign. By buying Compaq, she created a giant with tremendous scale and all of the clout and economies that come with it. But she did not fundamentally change HP's ability to fend off Dell in the low end of computing or match IBM's sophistication in the enterprise. So HP has come up short against both of them. Equally important, the battle over the merger divided the once-collegial company into angry, partisan factions. Insiders say the contentiousness of the dispute was a key part of why Fiorina became so wedded to her plan for HP.

But Fiorina's soaring vision ran into a wall of opposition. Director and scion Walter Hewlett rose up against it, and huge swaths of employees and shareholders joined the cause. They feared that the deal would dilute HP's lucrative printing and imaging business and an influx of hard-charging Compaq execs would turn HP's hallowed culture upside down. The dispute spiraled into a bitter proxy battle and wound up in the courts. Hewlett was pushed off the board of the company his father founded.

While it's convenient for HP's leaders to blame poor execution for their problems, what ails the company runs much deeper than replacing a few top executives. In enterprise computing, HP has failed to improve its lot. While it is

still narrowly the market share lead in storage and in key server markets, including Unix and PC servers, it's losing ground to EMC Corp. in storage and Dell Inc. and IBM in servers. In some cases, its technology just hasn't kept up. In others, it has made bad bets.

IN DELL'S SHADOW

THE BIGGEST OF those was forming a partnership with Intel Corp. to co-develop the Itanium processor as the brains for high-end servers. After half a decade of trying, Itanium has gained little ground. Meanwhile, HP stopped developing its own high-end processor, called PA-RISC. Now it's stuck slugging it out for share in the market for commodity servers that run on Microsoft's Windows—where Dell excels.

HP struggles just as much in software and services. Its tiny software unit lost \$125 million last year on just \$922 million in sales. It's highly unusual not to make money in enterprise software. In services it has a sizable but slow-growing maintenance and repair business, yet it has squeezed profits in an attempt to gain market share in managed services such as running corporations' IT operations. Acting CEO Wayman said during the company's press conference on Feb. 9 that while the

unit's revenues have been growing strongly, the company has to focus on profits now.

Even HP's gilded \$24 billion printing business, viewed by many as the company's savior, faces a rising number of challenges. Since Dell jumped into the market in early 2003, it has quickly picked up market share in inkjet models, the end of the business. During the first three quarters of 2004, Dell accounted for 15% of inkjet sales in the U.S., according to IDC. While still a fraction of HP's market share, it presents a troubling trend: a growing base of Dell printers means Dell could eat into HP's lucrative business selling ink refills to existing customers. "Dell is on the radar. It's a big long-term issue for Hewlett-Packard," says Michael Smith, a portfolio manager at institutional investor Munder Capital.

HP is betting that it can stay ahead of printers by pouring resources into R&D—and innovating constantly. In the future, the company expects state-of-the-art printing technology to spread into new domains, with printers even being harnessed to spray out billions of precisely engineered semiconductors. Though it spends more than \$1 billion on printing R&D, analysts question whether it can keep its edge. "The have the ability to carry it off, but not indefinitely," says D'Elia of researcher iSuppli Corp.

The management ouster at HP gave the company a chance to rebuild ties with investors. During Fiorina's 21 qu-

The board softened the blow with a \$21 million goodbye package



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ters atop HP, the company missed profit expectations eight times. Sure, that's better than the 21 quarters before Fiorina arrived. But it's also more than double the combined misses of IBM and Dell over the same period. "Investor credibility is a huge issue with HP" says analyst Laura Conigliaro of Goldman Sachs & Co. Indeed, in 2004, HP's stock plunged 8%, underperforming virtually every one of its competitors.

The good news for HP? Even if the board clings to Fiorina's vision, the next CEO is sure to have a bold mandate for change within the divisions. That's sorely needed. Take the PC business. Before

the merger, Compaq was making significant strides following Dell's efficient model of direct sales to customers. Yet when the companies merged, this initiative never won broad support. Why? HP couldn't aggressively push PCs and bypass retailers, when it needed their help to sell printers. The result: HP has stuck to the old industry model as it battles super-efficient Dell. HP's market share is eroding in PCs, and the division struggles to eke out a profit.

If the new CEO hangs on to the \$24.6 billion PC business, the boss is likely to move quickly toward the Dell model—even at the risk of angering retailers.

Should the direct-sales model sp the choices grow starker. IBM final solved the same issue in December ing its PC division to China's Lenovo \$1.25 billion.

More bold moves are needed in HP terprise business. While the compar quired more than a half-dozen small ware companies in the past 18 mon has balked at a bigger acquisition. Ins say that some board members were that Fiorina didn't more aggressively sue Veritas Software Corp., a profi maker of storage software that wa quired by Symantec Corp. in Decer The bottom line is that HP lost mon

The Inside Story Of Carly's Ouster

By the end of 2004, the pressure in Hewlett-Packard Co.'s corner office was almost unbearable. With Chief Executive Carleton S. Fiorina's efforts to fix the \$80 billion computing colossus stalled and tensions building with the board, one of high tech's most powerful executives began mulling an exit plan, *BusinessWeek* has learned.

Around the holidays, Fiorina held separate meetings with at least four high-profile chief executives to glean advice on making a "graceful exit" from HP, according to industry sources. These industry luminaries, approached by Fiorina at yearend business conferences, included Cisco Chief Executive John T. Chambers and Intel President Paul S. Otellini. During the conversations, Fiorina told the CEOs she was feeling some pressure from HP's board and inquired about face-saving ways to leave the company should she decide it was in the best interest of shareholders, according to the sources. Fiorina, Chambers, and Otellini didn't return requests for comment.

It was a decision she didn't get a chance to make. On the evening of Sunday, Feb. 6, HP's board hunkered down with Fiorina in an emergency meeting held at Chicago's O'Hare Hyatt Hotel. As a light rain drizzled outside, the directors stewed over their star CEO's failure to execute her ambitious plan for the company. In addition, directors were concerned about the "board's inability to

work constructively with [Fiorina]," according to an HP insider. The next day, they asked Fiorina to step down. And on Wednesday, Feb. 9, at 5 a.m. Pacific time, HP

stunned the world, announcing Fiorina's dismissal, ending her 5½ year stint atop on of the legends of Silicon Valley.

Despite the surprise announcement, the board's concerns about its chief had been mounting for nearly a year. Sure, she had dazzled directors and many investors with her passionate work in pushing through the controversial merger with Compaq Computer Corp. in 2002. And the immediate integration of the two companies bested expectations, silencing even her fiercest critics. But by late 2003, investors

Days of Promise Days of Pain

In five and a half turbulent years, Fiorina took a Silicon Valley legend on a wild and high-profile ride as she made her name as the most-powerful woman executive in America



JULY 17, 1999 Carly Fiorina takes over as CEO of Hewlett-Packard, the first outsider to run the Silicon Valley icon.

SEPT. 3, 2001 Fiorina and Compaq CEO Mike Capellas announce a controversial merger, spawning bitter opposition from board member Walter Hewlett.

MAY 3, 2002 After proxy victory, HP's with Compaq closes.

MARCH, 2003 Dell enters the printer market, threatening HP's crown.

DECEMBER, 2003 Dell ahead of HP in overall shipments during 2003.

are last year, despite it one of the most profitable markets for most core computing rivals. software business is behind what you'd expect from a company this says Goldman's gliaro.

HP embarks on a difficult transition, execs will be hard to put forth an air of calm and stability. company's business depends on it. Incompetitors from IBM to Dell to Sun are highlighting HP's management tur-

The new CEO will have a broad mandate for the change that's needed

moil as they compete on large corporate-computing deals. Even with longtime HP veterans, from Wayman to printers chief Vyomesh Joshi, sticking around, this promises to be a difficult task. "If somebody has a pen poised over a purchase order, HP doesn't want there to be a moment of hesitation," says Andy Butler, a vice-president at researcher Gart-

ner. "The company will go to great pains to show the world that nothing is changing right away."

While execs press forward with gritted teeth, the drama at HP seems to come full circle. Six years ago, it was at another airport hotel in Chicago that directors hired Fiorina. But things aren't going back to where they started. Not a chance. She may be gone, but HP now carries the indelible stamp of Carly Fiorina. ■

—With Steve Hamm and Spencer Ante in New York and Robert D. Hof, Cliff Edwards, and Peter Burrows in San Mateo

BusinessWeek online For more on HP and Carly Fiorina's ouster, please visit us online at www.businessweek.com

egan shifting their focus from the Compaq deal to HP's ebbing position against key competitors IBM and Dell. They bored in on the ragged financial performance that led to the swooning stock price. "[Fiorina's] good with marketing; she's a good speaker for the company," says a former HP executive. "But this is a company that doesn't need a statesman. It needs a hands-on operations person."

The tide really began turning against Fiorina following HP's massive profit shortfall in the third quarter of last year. That

marked HP's second miss in five quarters and further damaged the company's credibility on Wall Street—a major issue, since HP's stock has long traded at multiples well below those of its competitors. Although Fiorina fired three top sales executives for the miss, the board's doubts about its CEO grew. At the same time, the board's proddings of Fiorina to bolster HP's operations talent went largely unheeded.

As HP struggled to nail down its operations, some directors were chagrined

that Fiorina didn't move more quickly to strengthen HP's position against Dell and IBM. For instance, although HP has gradually built up its direct-sales efforts to better compete with ultra-efficient Dell, some directors felt the company wasn't moving fast enough, according to the HP insider.

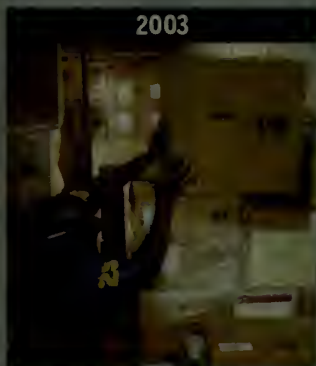
In addition, HP balked at a major acquisition to bolster its money-losing software business. In 2004, HP had considered acquiring Veritas Software but didn't move quickly enough, according to current and former HP execs. In December, Symantec gobbled up the profitable software company—leaving some HP directors unhappy. "Things needed to make us more competitive in certain segments weren't being done," says the insider.

By November of 2004, HP's directors began holding periodic conference calls—without Fiorina—to discuss their CEO's performance. And by the time of the board's January meeting in San Francisco, it enlisted three directors to meet with Fiorina to discuss its concerns with her performance. The trio produced a document indicating their concerns represented the consensus of the entire board.

The ensuing board meeting, which was supposed to be an annual strategy review, became focused on the performance of Fiorina and HP. And during the meeting, directors pushed forward a plan to distribute some of Fiorina's operating responsibilities to her key lieutenants. Sources familiar with the reorganization plans say they are on hold because of the management shake-up.

It was a heavy blow to Fiorina's credibility as the company's leader. Just weeks later, she was out. It had become increasingly clear that HP's need for a nuts-and-bolts operations whiz far outweighed the benefits of a high-profile CEO.

—By Ben Elgin in San Mateo, Calif.



'03

'04

FEB. 9, '05

2004 HP badly under-quarter earnings, raising questions about Fiorina's ability to execute

FEB. 9, 2004 Fiorina receives word from several sources that she will be "let go" from HP.

JAN. 12 - 15, 2005 HP's board holds an offsite meeting in San Francisco. Increasingly frustrated, the directors move to shift operating responsibilities from Fiorina to key lieutenants. They also bring former director Tom Perkins back to the board.

FEB. 7, 2005 At a meeting in a Chicago area hotel, HP's board asks Fiorina to step down. She agrees.

FEB. 9, 2005 At 5 a.m. local time, interim CEO Bob Wayman sends an e-mail to employees informing them of the management change.

STRATEGIES

HAVE DEALMAKERS WISED UP?

Acquiring companies seem to be taking a closer look—and paying less

WITH BIG NAMES, big dollars, and big payouts, deal-making is back on Wall Street. Following a runup of deals toward the end of last year, U.S. companies announced more than \$144 billion worth of mergers and acquisitions in the first 40 days of 2005—the fastest start since 2000, according to Thomson Financial Inc. SBC Communications' \$16 billion deal for AT&T on Jan. 31 was followed just days later by Qwest Communications International's \$6.3 billion bid for MCI. The same week, MetLife Inc. said it will pay \$11.5 billion in cash and stock for Travelers Life & Annuity, now owned by Citigroup. And Procter & Gamble Co. unveiled a deal to buy Gillette Co. for \$57 billion in stock, with a \$20 billion stock buyback to follow. As adrenaline-pumped CEOs face flashing cameras, it sure looks like deal fever is raging again.

Is it time for investors to worry? The list of failed deals from the late 1990s still resonates loudly in their collective memory. Daimler Benz's \$39 billion purchase

of Chrysler and Consec's \$7 billion deal for Greentree Financial were spectacular busts for their shareholders. And while America Online Inc.'s \$166 billion acquisition of Time Warner Inc. saved AOL shareholders from the even worse losses suffered by other Internet stock holders, it proved an epic mismatch that wiped out tens of billions of dollars of wealth, including all of Time Warner's takeover premium. The risks of the megadeal were underscored again on Feb. 9 when CEO Carleton S. Fiorina resigned under pressure from Hewlett-Packard Co. After pushing for the \$19 billion acquisition of Compaq Computer Corp. in 2002, Fiorina failed to achieve the promised growth and profitability (page 34).

The latest round of dealmaking could be different. Many of today's acquirers appear to have learned important lessons from the failures of the past. The recent spate of deals suggests that executives and directors are approaching takeover targets with a lot more care than in years past. They're giving more thought to strategic fit, paying lower premiums, and spending more time and attention on integration. "We haven't seen anything wild yet," says

Hugh "Skip" McGee, head of investment banking at Lehman Brothers Inc.

Of course, the odds are still against these mergers. Many studies over the decade show that the majority of M&A deals result in worse returns for shareholders of acquiring companies than their competitors. *BusinessWeek* invest



New and Improved **M&A**

Stung by the failure of many late '90s mergers, many companies are rethinking the playbook.

SLASH THE PREMIUM

Recent deals, including Procter & Gamble's purchase of Gillette and Johnson & Johnson's bid for Guidant, feature premiums of just 15% to 20%—less than half the rate common during the boom. By paying less, they ease pressure from Wall Street and gain time to integrate their purchases.

STAY CLOSE TO HOME

Companies such as Citigroup and IBM are largely shunning huge deals that would move them into new fields, instead favoring small acquisitions and divestitures to concentrate on their core businesses. J&J's purchase of Guidant, for example, builds its cardiac-device line.

PROCEED WITH CAUTION

With new accounting regulations requiring precise valuations, boards of directors are putting more time and effort into analyzing deals to ensure that they are worth pursuing. Some managers are privately talking to their targets' customers and suppliers.

FOCUS ON INTEGRATION

Buyers are working to bolster morale, retain key execs, and keep customers happy at the companies they've snatched up. Cingular Wireless has done extensive outreach to AT&T Wireless customers, while Bank America has moved slowly to integrate Fleet Financial.



ons in 2002 and 2004 showed that of big deals hurt the buying company's shareholders. Half of them also leave owners dissatisfied.

RE VIGILANT BOARDS

LL, DEALMAKERS are behaving differently these days. Buyers are generally offering smaller premiums. And many potential acquirers are barely bidding at all. Top executives at companies including IBM, Citigroup, and American Express have largely sworn off or passed on large deals. Instead they're using M&A to focus on their core businesses, buying relatively small companies while divesting only fitting units. With all the changes, says Jack Levy, co-chair of M&A at Goldman, Sachs & Co.: "I've got to believe there will be a higher success rate."

It's too early in this M&A cycle to make a call with certainty—plenty of overpriced, poorly thought out deals could still pile on. But at least some of today's speculation is likely to stick. Reforms imposed

by Congress and regulators have made corporate boards more mindful of their responsibilities, including the reviewing of deals. That has directors stepping up to challenge CEOs to prove that deals will pay off. "Boards are being much more careful," says Mark L. Sirower, leader of the M&A strategy practice at PricewaterhouseCoopers.

So far, investors like what they're seeing. SBC shares held their own as news leaked that it was looking to buy AT&T. MetLife stock slipped just a half of one percent when it said it was buying Travelers. And when Johnson & Johnson said on Dec. 16 that it was paying \$25 billion for medical-device maker Guidant Corp., its stock rose 4%.

The big reason investors aren't hammering buyers' stocks: Most acquirers have become cautious about not overpaying. Gone are the 30% to 40% premiums regularly paid in the past, much less the 50%-plus premiums that were common in 1999 and 2000. SBC offered AT&T virtually no premium over its market price, while Exelon paid just a 16% premium for Public Service Enterprise Group. Exelon's stock rose about 5% on the deal, a sign that investors figure it isn't paying the sellers so much that it's giving away all of the \$400 million in annual cost savings it expects by combining the companies.

This new sense of moderation extends beyond the price of deals. Some companies are staying away from the deal market altogether if they don't see a perfect fit. So far, Verizon Communications has held back as SBC snatches AT&T and Qwest pursues MCI (page 38). Some now follow the practice of private buyout firms that quietly interview a target company's customers, suppliers, and lenders before agreeing to a price, says David Harding, a director at Bain & Co. and co-author of the book *Mastering the Merger*.

Dealmakers' caution isn't all internally driven. New accounting rules for acquisitions and director-independence provisions in the Sarbanes-Oxley Act of 2002 are prompting boards to question deals early. More directors are asking for detailed appraisals of individual assets that would be bought, says Paul Barnes, a managing director at Standard & Poor's Corporate Value Consulting.

Another plus is that executives are often more intent on sticking with existing business strategies instead of chasing new

markets. J&J's purchase of Guidant, for instance, is part of a consistent strategy to build up its line of cardiac devices. And IBM hasn't bought a company to make a big, bold entry into a new market since its 1995 purchase of Lotus Development Corp. Yet it has acquired 40 other companies since then in smaller deals to fill product gaps and consolidate weak rivals.

Other companies are adjusting their M&A tactics. General Electric Co. is cutting back on how many small deals it does. One reason: The costs and time re-

quired to integrate are high regardless of a deal's size. "Integration doesn't come naturally," argues Pamela Daley, GE's vice-president for corporate business development. Others are changing more dramatically. Citigroup's strategy of building a financial super-market through M&A was turned on its head when it announced on Jan. 31 that it will sell its Travelers insurance

business to MetLife. Says Citigroup's new CEO, Charles Prince: "The days of doing big consolidating transactions that completely transform the company are behind us."

Buyers are also giving careful new attention to the critical issue of integration. A decade ago integration often meant slashing and burning, but these days managers are going to great lengths to keep the acquired company's customers happy. Bank of America Corp. lost droves of customers in its 1997 buy of Barnett Banks Inc. when it quickly closed branches and rushed to combine computer systems. Now, BofA is taking an extra year to integrate the \$47 billion purchase of FleetBoston Financial Corp. it closed in 2004. The payoff: BofA added 184,000 new checking accounts at Fleet in the first eight months after the merger.

Similarly, Cingular Wireless transformed 1,000 AT&T Wireless stores across the country to Cingular stores overnight late last year and gave AT&T customers instant access to Cingular's gear and networks. That helped Cingular quickly reduce AT&T Wireless' notoriously high churn rate.

As the latest round of mergers gains steam, many of these lessons may yet be forgotten by cocky corporate buyers. But for now these wheelers and dealers don't look as reckless as those of the past. ■

—By David Henry in New York, with Dean Foust in Atlanta, Emily Thornton in New York, and bureau reports

Some 61% of big deals hurt the buying company's shareholders

COMMENTARY

BY STEVE ROSENBUSH

Telecom: To Buy or To Build?

Why the industry is deeply divided over the best path to growth

THERE'S A GREAT debate among telecom industry leaders these days. Driving the industry consolidation are leaders like SBC Communications Chief Executive Edward E. Whitacre Jr. who see deal-making as the best way to grow quickly. That explains the flurry of talks to buy long-distance companies' still-lucrative yet shrinking business of providing telecom services to big corporate and government customers—

the so-called enterprise market. But execs at Verizon Communications and BellSouth have pursued a very different strategy. They seem to think that the way to expand and thrive in today's telecom world is by focusing on growth in the profitable wireless and broadband markets while building up in the enterprise market on their own.

Both sides are plunking down big money to pursue their different strategies. In the "buy growth" camp, SBC has recently agreed to spend \$16 billion to acquire AT&T, while Qwest Communications International hopes to grab MCI for \$6.3 billion. Conversely, BellSouth and Verizon have so far avoided deals, investing billions instead to build out their state-of-the-art wireless and broadband markets while also trying to expand their enterprise markets internally.

So who's right? SBC and Qwest no doubt have the bolder and more aggressive in-your-face strategy. Snatching up a long-distance company's enterprise business generates huge amounts of cash. And, unlike individual consumers who frequently change providers, big companies can't easily switch to a new phone company: They'd be forced to buy tons of new equipment, an expensive and time-consuming headache. That makes it hard for upstarts like Verizon and BellSouth to steal business from stalwarts like AT&T and MCI.

That hardly means Verizon and BellSouth should try to muscle into an enterprise deal. The problem with Whitacre's strat-

egy is that the enterprise business, though an \$85 billion market today, is fading fast. Revenues are shrinking about 1% a year. Profit margins are getting squeezed by stepped-up competition and the advent of Internet technology. In the enterprise market as a whole, operating margins before income, taxes and depreciation are expected to hit just 22% in 2005, down from 24% in 2004 and 26% in 2003, according to Muayyad Al-Labi, a managing director at market analyst RHK Inc. Contrast that with the 40% margins sported in wireless and broadband.

To make their deals pay off, SBC and Qwest are banking on a turnaround in the enterprise market within a few years. As they attempt to sell new Internet-based services to their enterprise customers, they foresee big gains. Right now such Web-based services account for only about 10% of the market. But over

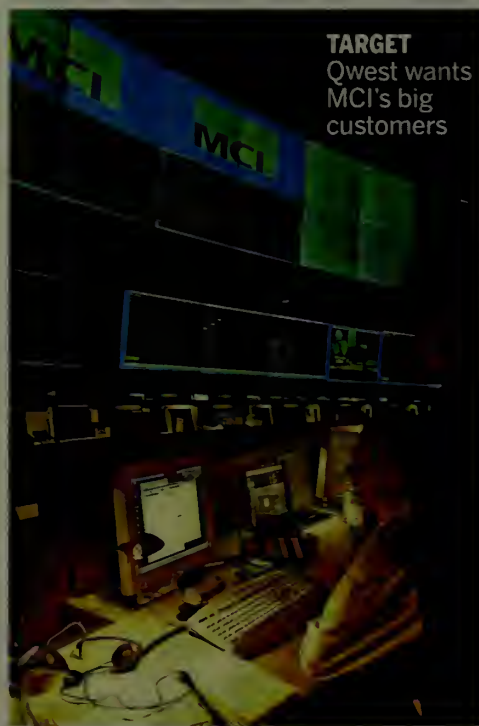
says SBC Chief Financial Officer Richard Lindner, "the math is in our favor."

Verizon and BellSouth aren't convinced that the potential for such gains is worth the high price of buying into the enterprise market. They figure there's just so much business to go around—and they're not going to wait. These companies are betting on growth in new technologies: building faster networks to allow them to sell high-speed Internet connections and services to big corporations. Says BellSouth CEO Duane Ackerman: "We are positioning our assets where they can grow."

No one really knows how wireless technology, optical networking, or regular old broadband, for that matter, will alter the competitive landscape. But as broadband and wireless technologies such as 3G and WiMax take hold, the definition of a low-cost telecom company could change fast. And that could leave AT&T and MCI as corporate traffic migrates to those technologies. Those risks make it hard to know what long-distance carriers are truly worth. Michael Mahoney, a senior

portfolio manager at San Francisco-based hedge fund EGM Capital, has estimated that AT&T is worth half of what SBC thinks it is.

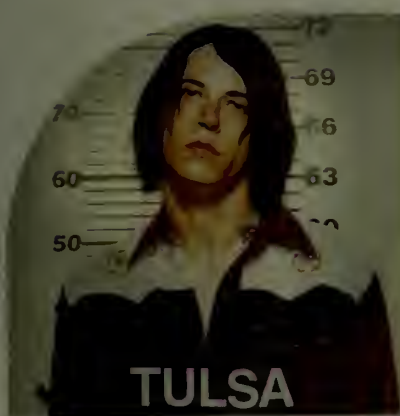
Qwest and SBC concede that it will be years before they'll realize the benefits of their desired acquisitions. And Verizon and BellSouth may yet decide to take similar risks. But that would be a mistake. SBC will be saddled for years with falling revenue as it takes on AT&T. Verizon and BellSouth can grow internally right now. The growth might be slower, and neither company is likely to ever dominate the market for enterprise services. But they can be successful without being king of that particular hill. ■



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SCHMIDT
Google's
profits surged
in 2004

THE INTERNET

KEYWORDS FOR AD BUYERS: PAY UP

It's costing more and more to link Net ads to popular search terms

EVEN GOOGLE'S BIGGEST boosters expressed surprise at the results. On Feb. 1 the search giant reported \$400 million in net earnings for fiscal '04—a whopping 278% gain—on revenue of \$3.2 billion. What accounted for the outsize profits? The high prices Google charges for search keywords, for one. Industrywide, they were up an average of 43.7% last year, according to search marketing firm iProspect.com Inc. And the most sought-after words have become far more dear: “background check” rose 258% in a year. On the day of the earnings announcement, Google CEO Eric E. Schmidt told analysts: “There does not seem to be price resistance” from advertisers.

Still, with keyword prices soaring, businesses from eBay Inc. to Espresso-Zone.com are rethinking how they use this powerful advertising medium. “It’s incumbent upon us...to figure out how to moderate these quite significant increases in media costs,” eBay Chief Executive Meg Whitman declared in January following disappointing fourth-quarter results, when rising search marketing costs helped pinch profit margins.

To ensure they get the best bang for their search-advertising buck, eBay and others are doing everything from using different search keywords to re-designing their Web sites. The goal: getting folks who click on their search ads to actually buy something. “Search advertising takes a significant amount of testing, work, and knowledge,” says George Collins, CEO of Espresso-Zone.com, a seller of coffee items in Ashtabula, Ohio. “Otherwise you’re just wasting money.”

The approach to purchasing keywords is changing fast. Companies bid

to place their ads alongside keywords relevant to their products. A travel agent, say, might bid on “Caribbean cruise” and “airline tickets.” But many advertisers have found such generic keywords to be pricey and less likely to cover the ad cost. Instead, they are bidding on a larger array of more specific keywords: a telecom company might choose “wireless plan” rather than “cell phone” in an effort to lure the most interested buyers. In the past year the average advertiser’s roster of keywords grew by 50%, according to Efficient Frontier Inc., a Mountain View (Calif.) company that manages \$100 million in keyword purchases for its clients.

At the same time, online sellers are looking for ways to capture customers after the search ad has directed them to their Web site. There’s plenty of

room for improvement. Commerce sites typically convert 2.4% of visitors into customers, according to a study by the National Retailer Association. The proliferation of broadband should help that number. According to e-tailers, broadband users are as much as 10 times as likely to become paying customers than those using dial-up modems, which slow shopping.

SNAPPIER PRESENTATION

E-TAILERS ALSO ARE researching how visitors navigate their sites and are working to better convert them into long-term customers. One way: customizing the retailer’s “landing page”—where the searcher is first directed—to a specific keyword. That makes it easier for a customer to get the info she wants and more likely that she will buy.

One company especially adept at converting search ads into customers is Shopping.com. Thanks to its improved presentation of information, prices, availability, and the like on a wide range of products, the comparison-shopping site says it raised conversion rates on those products more than a third. That means every search visitor became one-third more valuable, making it easier for Shopping.com to afford the rising cost of keywords. And that, of course, is good news for Google. ■

—By Ben Elgin, with Robert D. Finkelstein in San Mateo, Calif.

Click, Ka-Ching!

For advertisers, the price of popular search terms is soaring

SEARCH KEYWORD	CURRENT PRICE*	12-MONTH GAIN
Background Check	\$1.18	258%
Car Loan	1.34	123
Refinance	4.46	115
Electronics	0.26	100
Personal Bankruptcy	1.15	47
Airline	0.27	42
Auto Dealer	0.37	37
Vacation Package	0.38	31

* Per customer click, as of 1/17/05

Data: iProspect.com Inc.

Security Systems

Closed Circuit TV

24/7 Mobile Services

Mission-Critical Environments

Operation and Maintenance

Audio/Visual Systems

Remote Monitoring and Dispatching

Voice and Data Cabling

Cable Tray Installation

Air Quality Testing and Correction

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Standby Power Systems

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AUTOS

FORD: IS CAUTION KILLING A COMEBACK?

Bland styling is keeping its recent crop of family sedans on dealers' lots



A YEAR AGO AT THE Detroit Auto Show, Ford Motor Co. kicked off its much-hyped "Year of the Car." In 2004, the auto maker proclaimed, it would roll out a bevy of new models to reverse the decline it had suffered in the passenger-car market. It also aimed to shore up its position in the crucial family-sedan segment that it once led with the Taurus. But with little improvement to show since the new cars arrived in showrooms last fall, Ford's big comeback looks less than convincing.

Sure, two sexy low-volume models, the Mustang and the GT sports car, are selling briskly. But the trio of family sedans—the Ford Five Hundred sedan, the Freestyle crossover wagon, and the Mercury Mon-

tego sedan—are off to a slow start. In January all three sold fewer than 11,000 units, far shy of the 20,000-plus clip Ford needs to hit its annual goal of 250,000 cars. And while dealers say the Five Hundred is generating showroom traffic in parts of the U.S., inventory is piling up. Ford now has 122 days' supply of Freestyles on hand—about twice the level carmakers typically like to have in stock.

Why? They are, in a word, dull. "The Five Hundred and Freestyle are not bad cars," says Global Insight Inc. analyst John Wolkonowicz. "They just blend into the woodwork." Ford insists that because the cars are less in-your-face than, say, the hot-selling Chrysler 300, they'll take a little longer to find an audience. "Already, this month, the Five Hundred is beating its objective," says Ford Div. President

Stephen G. Lyons. But the auto maker's recent actions belie its public posture: it is planning a face-lift for the Five Hundred—two years earlier than usual.

Tepid reactions have also ratcheted the pressure on Ford's design staff. Recent executive shuffle puts the burden of improving Ford's styling squarely on the shoulders of Peter Horbury, the British designer behind Volvo's renaissance who was named chief of North American design in December, 2003. Global design chief John Mays, who embodied Ford's American design efforts for six years, moved to London at the end of 2004 with an added title: chief creative officer. The move led to widespread speculation that Mays had been reassigned. Mays flatly denies that, saying he has lobbied for 18 months to relocate to Detroit, currently ground zero for hot car design. "I'm doing exactly the same thing as before," Mays says. "I'm just putting my head on a pillow in a different place."

TOPPLED CROWN

SO HOW DID FORD wind up with two snoozers to lead its planned revival? The story begins in the mid-'90s. That's when Ford introduced the redesigned Taurus, with its rounded styling, hit the market with a top-selling car. Losing the crown of America's best-selling car. Stung by the flop, Ford design turned cautious. Bland styling worked for the segment-leading Toyota Camry and Honda Accord, they reasoned. Why not Ford? At the same time, Ford, averaging profits from its hot-selling trucks, decided to go upmarket. Giddy planners thought the Five Hundred and its siblings would compete with Toyota Motor Corp.'s \$26,660 full-size Avalon. "It was a premium product at premium prices," says a source close to the product.

When Ford bought Volvo in 1999, engineers seized on the Swedish company's flagship S80 sedan as a basis for their new cars. The Volvo platform, although costly to build, offered lots of safety features and an all-wheel-drive option. But the platform's unusual dimensions made it tricky to design around. Horbury rose to the challenge at Volvo: pulling off a sleek sedan that turned heads. Mays, widely praised for helping design the New Beetle in his previous job at Volkswagen, oversaw the team working on Ford's three new cars. But

**Ford's
Pile-Up**
Days worth
of inventory

PONTIAC G6

123

FORD FREESTYLE

122

FORD FIVE HUNDRED

118

MERCURY MONTEGO

109

HONDA ACCORD

77

INDUSTRIAL

71

Data: Ward's Automotive Ltd.

struggled to find an elegant way of ang the sheet metal over the S80's ge shape, say people involved in the t. And despite a ho-hum response focus groups, several of these people ne models got the green light amid gement turmoil in 2001.

nd got its first jolt of bad news last ner. The "buff books" yawned—they weren't trashing the new ls. Wrote Pulitzer Prize-winning reviewer Dan Neil of the *Los Angeles* s: "There is no soul to this car, and out as sexy as going through your er's underwear drawer." Of course, the same has been said about the of the Camry and Honda Motor Accord. But they have such a strong ation for quality that buyers are will- overlook their bland styling; to dis- them, Ford needed to offer some- much more interesting.

he Five Hundred also hit the market after DaimlerChrysler's new family n, the Chrysler 300. Not only did the sport the brash styling and horse- er that car buyers crave, but Chrysler priced the new model to start at \$9,595. That pressured Ford into drop- the Five Hundred's base price to \$9,795, nearly \$5,000 less than origi- planned, one source says. Worse, the cars sit in dealer showrooms along- older models boasting rebates of \$1,000 or more. Says James Hall, vice- ident of consultant AutoPacific Inc.: "I end up competing with yourself." Ford execs insist there's nothing wrong with the Five Hundred and its siblings. But he concedes there's room for improve- t. "In hindsight, would we have pre- d more of a bold statement?" asks yl B. Hazel, president of Lincoln-Mer- . "I think so." Enter Horbury. Ford es the man who made Volvos stylish work the same magic on its U.S. ds. And Horbury clearly knows more nctive styling is a must. "My job is rid- on it," he says.

ord is betting its cars will gather mo- tum in the spring, when many people k for new wheels. But if sales don't k up, Ford's Year of the Car could turn to be another Year of the Rebate. ■

—By Kathleen Kerwin, with David Welch, in Detroit

AUTO MAKERS

Later for You, Mom



Can Honda get its street cred back? For years the Japanese carmaker earned the loyalty of young buyers thanks to the first-rate reliability and sporty ride of its Civic. The high-revving engine and tight handling of the popular compact made it the ride of choice among the trend-setting "tuner" crowd—West Coast kids who amp up the horsepower to convert cars into cheap hot rods. But when it redesigned the Civic back in 2001, Honda decided it was time to graduate to a more mature market.

Big mistake. In appealing to moms with a more staid and cushy Civic, Honda took the tuners for granted. Even though the new car still performed well on the test track, Honda's rivals made a concerted push for young buyers—and Civic sales went soft as kids turned to Toyota, Hyundai, and Mazda for jazzier cars.

Now Honda Motor Co. is scrambling to reverse that skid. At the Chicago Auto Show on Feb. 10, it unveiled a concept version of a brand new Civic that is set to hit showrooms this fall. And not just any concept: Honda showed off the performance version of the car—the racy-looking, 200-horsepower Civic Si. Take that as a less-than-subtle message to Honda's erstwhile fans that the Japanese auto maker is reverting to form. Says American Honda Motor Co. Executive Vice-President Richard Colliver: "You'll see the new Civic go more sporty and youth-oriented."

Honda needs the new car to be a hit. With sales of 330,000 units as recently as 2001, the Civic accounted for as much as a quarter of Honda's U.S. sales and still holds

PERFORMANCE Honda's racy Civic concept

more than 13% of the compact market. Civic's share has ticked up as the

compact segment has shrunk, but for the first time its sales—off 7% from the peak—have fallen behind Toyota Motor Corp.'s Corolla line, which includes the Corolla Matrix compact sport wagon.

Honda picked the wrong time to get conservative with styling and performance. Just as it softened up the Civic, rivals were headed in the opposite direction. The Mazda 3, launched in 2003, took a bold design

direction and went for tight handling. And Toyota launched its Scion brand with the intention of attracting younger buyers. It seems to have succeeded: While plenty of older, budget-conscious folks have snapped up the Scion, the average age of owners is 30, low by industry standards. And the average age of the Civic buyer? A comparatively creaky 40.

So what is Honda doing to woo back the younger set? The company is providing few details, but insiders say even the base model Civic will get Honda's zippy i-VTEC engine. A sportier suspension is also planned. And the Si concept shown in Chicago looks a whole lot racier, hinting that the new Civic will have snappier design flair than its predecessor.

Analysts say Honda still has plenty of cachet with younger buyers. If the new Civic delivers—and the new ads don't target young moms with a backseat full of kids—Honda can reconnect with twenty-something hot rodders.

—By David Welch in Detroit

THE STAT

**309
THOUSAND**

Honda Civics sold last year, off 7% from the 2001 peak

Data Autodata Inc.

MRY CHEVY MALIBU CHRYSLER 300

46

41

EDITED BY MONICA GAGNIER

HEADLINER

HENRY MCKINNELL



HEROIC MEASURES

Pfizer's chairman and CEO may be readying the ax. On Feb. 8, Henry McKinnell confirmed he is studying how best to "streamline the organization." While McKinnell, 62, declined to say whether his review will lead to job cuts, Friedman, Billings, Ramsey Group analyst David Moskowitz says Pfizer may slash \$3 billion in costs over the next several years.

A lot is riding on a Food & Drug Administration meeting on the safety of Cox-2 painkillers that begins on Feb. 16. If Pfizer's \$3.3 billion drug Celebrex is pulled from the market or restricted, McKinnell may have to cut jobs quickly.

The Celebrex headache is only one of several problems. Some big drugs will soon face generic rivals, and Pfizer faces a court fight over two patents on its \$10 billion cholesterol drug, Lipitor. McKinnell believes Pfizer will prevail. "We have challenges," he concedes. "But we clearly have the best operating capability in the industry." Still, that doesn't mean there isn't room for improvement.

-Amy Barrett

BOEING TAKES WING

Boeing Commercial Airplanes is gaining momentum. Its latest customer: **SpiceJet**, a new discount airline from India, which agreed on Feb. 9 to purchase 10 of its 737-800 airliners at a list price of \$630 million. The SpiceJet order follows a \$1.8 billion deal with **Japan Airlines** for 30 737s and six of the short-haul jets for **Air Libya**. What's more, orders for Boeing's new fuel-sipping 787 airliner are starting to arrive. Five Chinese carriers ordered 60 of the lightweight 787s, while **Ethiopian Airlines** said it would buy 10 of the planes. On Feb. 2, Boeing raised its forecast of expected deliveries. Driven by Asian and Middle Eastern demand for the long-range 777 and the smaller 737 models, Boeing now expects 2006 deliveries to grow more than 17% over 2005 (page 93). The first delivery of the 787 is expected in 2008.

KASH KRUNCH AHEAD?



New CEO Stephen Cooper is starting to cut the fat out of beleaguered **Krispy Kreme Doughnuts** (page 14). On Feb. 8, the restructuring specialist said he is cutting 125 jobs, or 25% of the workers at Krispy Kreme's Winston-Salem (N.C.) headquarters and its manufacturing and

distribution facilities. At the same time, Krispy Kreme said it recently unloaded a corporate jet. The moves should generate \$10 million in annual pretax savings. Still, even that may not be enough to stave off a looming cash crunch. The company warned that unless its lenders agree to the reopening of a key credit line in the next two months, it may not be able to fund its ongoing operations.

AIG WEATHERS ITS STORMS

Hurricanes and regulatory scandals failed to dent **American International Group**. On Feb. 9, the New York-based insurance and financial giant reported its annual profits jumped 19.1%, to \$11.05 billion. Revenue rose 21.3%, to \$98.6 billion. That's despite \$683 million of aftertax losses due to natural disasters like the hurricanes and tsunami, as well as \$53 million to settle charges stemming from regulatory probes. AIG's strength amid such turmoil is due to diversification, says Chairman Maurice Greenberg. Its insurance operations in foreign countries such as China continue to thrive.

TWO FAT FINES FOR BofA

Five **Bank of America** units settled charges of improper mutual-fund trading with the Securities & Exchange Commission on Feb. 9 by agreeing to pay a total of \$515 million. In one case, **Bank of America Capital Management, BACAP Distributors**, and **Banc of America Securities** agreed to pay \$375 million to settle charges that they let large

investors make rapid and illegal late mutual-fund trades. In a second case BofA's mutual-fund unit **Columbia Management Group** and its distributor agreed to pay \$140 million to settle charges related to undisclosed market-timing. As is customary, BofA settled all charges with the SEC without admitting or denying guilt.

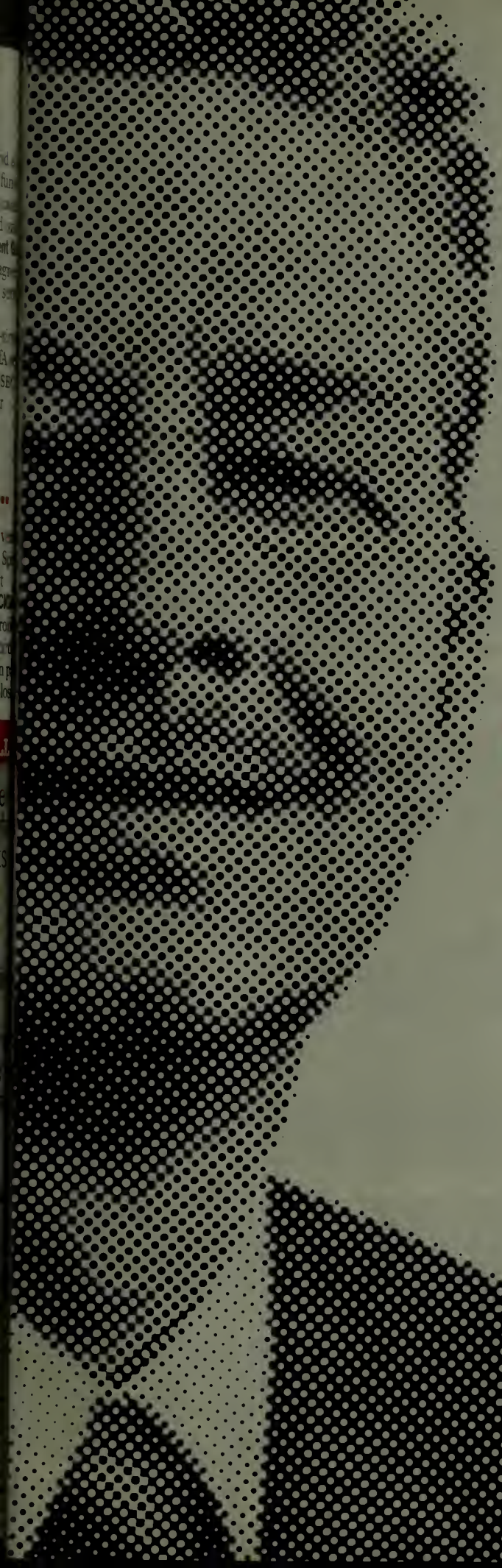
ET CETERA...

- » Coke is rolling out a version of Diet Coke made with Splenda.
- » Better medical cost management helped **CIGNA** double its quarterly profit.
- » Insurer **MetLife**'s fourth-quarter earnings fell, in part because of investment losses.

CLOSING BELL

Three weeks after slamming **eBay** for barely missing its fourth-quarter profit estimate, investors saw a buying opportunity. After analysts commented on the potential for eBay's PayPal finance arm and its Chinese unit, shares rose 4.5%, to \$78.99, on Feb. 8 and 9.





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Reiner Schmitt, IT Manager
SAP AG



ACCESS

INFRASTRUCTURE FOR THE ON-DEMAND ENTERPRISE

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SIEMENS

Global network of innovation



EDITED BY LEE WALCZAK

Why Farm Subsidy Cuts Light Actually Stick

GROUPS HAVE PROVED as loyal to President George W. Bush as farmers and ranchers. Bush claimed 64% of the rural vote in November—and more than down-home values were at work. The Great Rancher endeared himself to red-state rurals by signing an \$8 billion farm bill in 2002 so laden with subsidies that govern-

ment support now accounts for nearly a quarter of all U.S. farm income. But as the Administration struggles with \$400 billion in budget cuts, White House budget-cutters have turned their farm friends, proposing to slash \$1.2 billion in direct payments and to cut subsidies to individual farmers at \$1,000 in the fiscal 2006 budget.

It's Good Timing

NEBRASKA GOVERNOR Mike Johanns, whom Bush recruited to head up the Agriculture Dept., hints that the rejections may just be the beginning. On Feb. 7, Johanns even suggested that farmers buy their own crop insurance instead of relying on federal payments for weather-related losses. Farm groups are outraged. "From this perspective here is what we gave [Bush] the...and now we are being clobbered," says University of Nebraska political scientist Loree Berk. Led by the American Farm Bureau Federation, 151 farm and ranch groups wrote Johanns that the cuts come at precisely the time that these supports are most needed."



POINT MAN
Johanns has hinted more cuts will follow

urban investors are all ideas with appeal—even in Iowa. Bush's proposal led Senator Charles Grassley (R-Iowa), the only working farmer in Congress, to praise the Administration for "the wisdom in developing reasonable, legitimate payment limits."

Studies indicate that about 10% of farmers collect nearly 70% of subsidies. Huge cotton and rice farms in Texas and California are big winners. And hefty payments flow to wheat, sugar, soybean, dairy, and corn producers. Left out: Family cattle and hog farms in the Midwest and fruit and vegetable growers throughout the nation.

Farmers not on the dole have more pressing issues than protecting the subsidies of their brethren in overalls. Fruit and

vegetable growers, intent on preserving a ready supply of cheap labor, are eager for passage of Bush's proposal to grant guest-worker status to illegal aliens. Export-dependent U.S. pork and beef producers want to press for a global trade agreement in the stalled World Trade Or-

ganization talks. But as long as America coddles its grain farmers, other nations won't drop import tariffs on U.S. meat.

In the past, farm groups from llama ranchers to peanut growers to beekeepers united to fight off even modest reforms. Lately, though, the grand coalition has shown signs of strain—especially since tobacco growers and sugar producers have been singled out for cuts. If the Bush Administration can portray the nation's pampered grain producers as receiving more than their share, it could divide and conquer. ■

—By Paul Magnusson

CAPITAL WRAPUP

CORPORATE SCANDAL AND POLITICAL GIFTS

ARE COMPANIES that make undisclosed political donations bad for shareholders? Yes, says the Center for Political Accountability, a nonpartisan watchdog group. On Feb. 14 the center will unveil a report rating the decision-making and disclosure policies of 120 large companies that donated soft money in 2002 to the independent political groups known as 527 committees. Companies that didn't disclose their gifts were more likely to run into management scandals—think Enron—or reputational risk, as at PepsiCo and SBC Communications.

The analysis of under-the-radar giving could bolster support for shareholder resolutions seeking greater disclosure and accountability of corporate political donations. A dozen big institutional investors have submitted more than 30 such resolutions at companies including General Electric, Verizon, and Eli Lilly.

SCIENCE AND THE BUDGET: WHEW!

SCIENTIFIC GROUPS are warning that flat or reduced funding for many areas of science, technology, and science education in President Bush's 2006 budget will threaten America's future ability to innovate. But they also concede that the budget isn't as bad as they had feared. The White House's opening salvo included a 5% cut for the National Science Foundation and a 2% cut for the National Institutes of Health. Instead, both agencies got tiny increases in current dollars. That still leaves their funding lagging in real terms—especially at NIH, facing steep medical inflation.

IRAQ

MOSQUE AND STATE: JUST HOW CLOSE?

Iraq's new government may be more influenced by Islam than the U.S. hoped

IS IRAQ ON ITS WAY TOWARD becoming an Islamic state? As the vote-counting winds down from the country's Jan. 30 election, the broad outlines of the outcome seem clear. The largely Shiite group called the United Iraqi Alliance, blessed by Ayatollah Ali Hussein al-Sistani, Iraq's most influential Shiite cleric, will be the largest by far in the 275-seat National Assembly. That puts the Shiites in prime position to influence the choice of a new government and the writing of Iraq's permanent constitution.

But don't expect an Iran-style government dominated by mullahs-turned-politicians. The reclusive 74-year-old Sistani comes from the Quietist school of Shiite scholars, who think it's a mistake for clerics to run the affairs of state—a view reinforced by the shortcomings of the regime next door in Iran. But the degree to which religion will govern future Iraqi society is still far from decided. Even if the clerics stay out of politics, Iraq may be on the way to a system where religion and religious laws play a bigger role than U.S. policymakers anticipate, possibly thwarting cherished American goals such as broadening women's rights and creating a freewheeling capitalist economy. "The main goal in political Islam hasn't been clerical rule. It has been the replacement of civil law with Shariah, or Islamic canon law. And that is where Iraq is headed," says Juan Cole, professor of modern Middle Eastern history at the University of Michigan. "The only question is how wide-ranging the substitution will be."

If the Shiite parties allied with Sistani get their way, it's a good bet that religious authorities will gain greater influence. Most specialists think the shift, which is

already occurring, will be limited to family and social matters such as marriage, inheritance, and possibly education. It seems unlikely that one community will impose their system on another. Instead, Shiite and Sunni Muslims and Christians may wind up with their own religious family courts.

What's unclear is whether religious influence will spill over into commerce. That would mean measures such as bans on banks charging interest and pressure on those participating in activities considered immoral, such as gambling and the sale of alcohol. The Shiite politicians may want broader strictures on the economy to achieve social justice. Cole thinks they might look askance at the free trading of currencies and the transfer of money out of the country. There's even a text laying out a Shiite view of economics. Mohammed Baqir al-Sadr, the founder of Iraq's political Shiite movement who was executed in 1980, wrote a well-known

book named *Our Economy*, which called for regulating the economy by the "principles and ethical values of Islam." Such principles, however, will depend on who becomes Prime Minister. One of the leading candidates, current Finance Minister Adel Abdel Mahdi, is a free marketeered by U.S. officials despite his affiliation with a religious party, the Supreme Council for the Islamic Revolution in Iraq (SCIRI). Other figures may turn out to be skeptical of unfettered capitalism.

REVERBERATIONS IN IRAN?

AMONG IRAQIS, the debate on Islam's role is gathering steam. Since the election, some have released statements pushing for Shariah law to be the basis of Iraq's future constitution legislation. But on Feb. 8, a SCIRI spokesman tried to allay fears by saying that the Ayatollah merely wanted a constitution "to respect the Islamic cultural identity of the Iraqi people." Ghassan Jawad, an official of the Al-Khoei Foundation, a Shiite institution in London, says the Najaf clerical establishment just wants Islam mentioned in the constitution. "That doesn't mean the only source for legislation is Islam," he says. Any greater emphasis on Islam would make many Iraqis uneasy. The Kurds, likely to constitute the second-largest bloc in the Assembly, will resist the application of Islamic law in their area.

Should the U.S. be worried about these developments? "We should watch," says Phebe Marr, an Iraq scholar at the U.S. Institute of Peace in Washington. "I think the red line would be clerical domination of the state." But she adds that social issues—from the trivial, such as banning alcoholic beverages, to the

Islam's likely role in Iraq

FAMILY Islamic law is likely to prevail in matters of marriage, divorce, inheritance

COMMERCE Islamic law forbids interest payments but a national ban is unlikely

ROLE OF CLERICS They'll wield influence behind the scenes, but direct clerical rule is unlikely

Data: BusinessWeek

A Shiite-led Iraq could be a wild card in an unstable region

in the election, may be power brokers.

One problem for Sistani is that his own group is far from monolithic. Two religious parties form its backbone. The Islamic Da'wa Party has agitated for an Islamic state in Iraq since the late 1950s. The other, SCIRI, is a Da'wa offshoot nurtured by Iran in Saddam's era. But it also includes more urbane personalities, such as Ahmed Chalabi, the former Pentagon favorite now making a comeback.

Some Shiite politicians are skeptical that this patchwork group will be able to agree on much beyond protecting the rights of Shiites. "I don't think the Shia are capable of having a unified approach to politics beyond the necessity of removing discrimination," says Ali Allawi, a politician allied with Sistani. "Once the discriminatory structures are removed, the Shia as a politically unified grouping will dissolve." If so, fears of a religious state would ease.

But powerful forces may still keep pushing Iraqi society in a religious direction, whatever shape the constitution takes. Once among the more secular countries in the region, Iraq was taking on a more pronounced religious coloring even before Shiite and Sunni clerics began to fill the postwar vacuum left by Saddam's fall. Militias tied to the religious parties also exert huge influence in some areas. The southern city of Basra, once relatively secular, has come to look a lot like Iran: Women are afraid to go outdoors without headscarves for fear of reprisals from the SCIRI-affiliated Badr brigades, as well as other toughs associated with the firebrand cleric Moqtada al Sadr. For ordinary Iraqis, who rules the streets may for years be more important than what ends up in the constitution. ■

—By Stanley Reed in London



CELEBRATION
Sistani's bloc was a big winner

ortant, such as limiting women's ts—are matters for Iraqis to decide. said we wanted democracy there," says. "This is what happens."

Shiite-led Iraq could be a wild card in region whose hidebound regimes, stly led by Sunni strongmen and monns, are under pressure from without within. Such a change might add to restiveness of downtrodden Shiite mities, including the one that inhabits di Arabia's oil-rich eastern province. eady, the fall of Saddam Hussein has n a boost to Iran, energizing the pilmage and trade traffic between the two ntries. Yet if Iraq proves a more suc- sful model of Islamic-inspired rule n Iran, its example could help under- ne the Iranian mullahs.

ow Sistani plays his cards will be key.

So far it's hard to fault his gamesmanship. Since the fall of Saddam in 2003, the Iranian-born cleric has played the Iraqi nationalist, refusing to meet Americans and insisting on the elections that would bring the Shiites to power. Yet he has also urged his followers not to fight against American forces and cautioned against reprisals for attacks on Shiites by Sunni suicide bombers. Sistani obviously sees the wisdom of acting with restraint—and the Shiites will have to compromise with other groups to keep Iraq intact. The new National Assembly must choose a three-person presidential panel that will select the Prime Minister, the most powerful job. That will require a two-thirds Assembly majority. The Kurdish coalition and Prime Minister Ayad Allawi's secular grouping, which looks likely to place third



TSUTSUMI PLANT
big challenge
Higher prices
sheet steel

JAPAN

A 'CHINA PRICE' FOR TOYOTA

The auto giant is taking its cost-slashing drive to a new level. Can its suppliers match China's cheaper parts?

FIVE YEARS AGO, TOYOTA Motor Corp. stunned the auto world by embarking on a plan to slash costs 30% across the board for the car parts it buys—from air-conditioning ducts and door-assist grips to windshield wipers. The bold plan to squeeze its own network of traditional suppliers, known as a *keiretsu*, was designed to make sure the Toyota group would retain its competitive edge against a spate of global auto alliances

such as DaimlerChrysler, which promised gigantic synergies from their bigger size.

DaimlerChrysler is still struggling to make its merger pay off. But Toyota's cost-cutting program—dubbed CCC21, or Construction of Cost Competitiveness for the 21st Century—has been a remarkable success by any measure. With just one year to go, the plan is on track to save the auto maker some \$10 billion over its five-year time frame. Not only is CCC21 sourcing components more cheaply but Toyota has also improved the parts' quality.

But where does Toyota go from here? Even after putting its supply network through the wringer, Japan's No. 1 car maker can't afford to rest easy. In fact, there's more pressure now to cut costs than ever. The drive is on to replace expensive materials, benchmark Toyota's auto parts against Chinese-level pricing, and squeeze its Japanese suppliers further, relying more on non-*keiretsu* parts makers. "We need to adjust our cost-cutting drive to meet a whole new set of challenges," says Katsuaki Watanabe, 62,

ive vice-president who helped de- and supervise CCC21. In a sign that aligning is still a top priority, the ny announced on Feb. 9 that abe will take over as president of a from Fujio Cho in June.

L SHORTAGE

NABE IS a demon at spotting un- ary costs and eliminating redun- es. Under his prodding, one Toyota l team disassembled the horns by a Japanese supplier and found to eliminate six of 28 components, ing in a 40% saving. No part has too mundane to escape the Watan- quad's notice. His favorite example: or assist grips above each door. Once were 35 different grips. Now, a's entire 90-model lineup uses just basic styles. Toyota gearheads call process *kawaita zokin wo shiboru*, or ing drops from a dry towel."

t even Watanabe needs a new game to counter what's coming. Among most pernicious threats: the surge in s of crucial items such as sheet steel o higher costs for raw materials like ore and coal. Blame China's vor- demand for steel and a shortage of blast furnace capacity—factors that go away anytime soon. s more, the strong yen cuts Toyota's reported profits from de Japan, increasing the pres- to cut expenses.

ese burdens come just as the motive giant's latest cost-cut- push has started to run out of n. On Feb. 3 the company ac- vledged its cost cuts will likely just \$1.7 billion for the fiscal ending in March, 15% short of annual target, in large part due to steel prices. To cope, Watanabe shing Toyota to winnow down number of steel parts it uses in average vehicle from 610 to t 500. Toyota will probably to more steel substitutes such aluminum and heavy-duty ad-

ed plastics and resins. Moving away steel goes hand-in-hand with the pany's longer-term goal of cutting the ght of its vehicles to increase fuel effi- cy and rust-proof durability. hat said, there's a limit to how many parts Toyota can replace. Something e is needed—and that's the China benchmark. Under CCC21, Watanabe's enants identified about 180 key parts, figured out who were the world's t competitive suppliers of those s—companies like Robert Bosch of

Germany, Troy (Mich.)-based Delphi Corp., and the Toyota Group's own Denso Corp. The Toyota cost cut- ters used this information as the "benchmark" against which Toyota's *keiretsu* suppliers had to compete. The *keiretsu* outfits must approach the benchmark—or risk losing the business.

Now the exercise goes to a whole new level. The boom in auto production in China is nurturing a supercheap car-parts industry. For now, Chinese companies are mostly producing commodity-type components such as assist grips, not high-end modules and core parts like brakes. But Toyota officials say the rise of China has raised the bar for its *keiretsu* suppliers. "China has become an important new benchmark for us," says Watanabe.

This doesn't mean Toyota will soon start importing lots of parts from China. Analysts say it may be a decade before the partsmakers in China can go toe-to-toe with components made in Japan and the U.S. The ultralow defect rates for parts made in Japan, for example, can be as important to cutting prices as cheap fixed

Toyota is raising the bar on the keiretsu by seeking bids elsewhere

out everything from air bags to transmissions, are now more willing to meet demanding specifications. Toyota won't say how many of its parts come from outsiders, but non-Japanese suppliers are eager to win a bigger share. No wonder: The auto maker expects global sales to hit 8.5 million vehicles by next year, about 1 million more than in 2004.

That will put it on par with General Motors Corp., the world's largest carmaker. Non-*keiretsu* suppliers would love ultimately to win Toyota orders on a global basis—including in Japan, where local suppliers account for all but a small fraction of parts purchases.

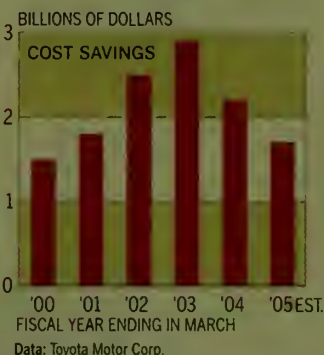
PART OF THE FAMILY

TO SHOW THE DEPTH of its commitment, Delphi now sends technicians to Toyota City to collaborate on the blueprints for new parts, and invites Toyota execs to tour its plants and offer suggestions for improving productivity and quality. Although Delphi won't disclose how much business it does with Toyota, less than 10% of its roughly \$1 billion in

Toyota's Cost Cutting

Since 2000, the Construction of Cost Competitiveness for the 21st Century—CCC21—has helped Toyota cut procurement costs by nearly a third. But as the program winds down, Toyota is looking for new places to trim the fat.

SAVINGS SO FAR...



...AND WHAT'S NEXT

- Cutting steel parts in cars from 610 to 500 to deal with the soaring cost of steel
- Forcing some component makers to meet or beat rock-bottom prices offered by suppliers in China
- Buying from more parts manufacturers not affiliated with Toyota's *keiretsu*, or corporate fraternity

Data: Toyota Motor Corp.

costs. Even so, the goal is to come as close as possible to matching the price without sacrificing quality. That involves rethinking everything, from the number of designers assigned to making any one part, to the supply chain involved in sourcing components, to the utilization rates of equipment at a parts factory.

The China benchmark will increase the pressure on Toyota's traditional suppliers. But so will the company's efforts to court more non-Japanese suppliers. And parts makers like Bosch and Delphi, which turn

Asian revenue comes from the Japanese. The company, however, says it has high hopes for supplying more to Toyota from its 13 plants in China. "We are becoming part of Toyota's extended *keiretsu* family," says Choon T. Chon, president of Delphi's Asia Pacific unit. And part of Watanabe's ruthless drive to cut costs to the bone. ■

—By Chester Dawson in Toyota City

BusinessWeek online For an analysis of Watanabe's appointment as Toyota president, see www.businessweek.com/extras



GERMANY

THE CHINESE ARE COMING... TO GERMANY

Mainland outfits are opening up shop—and gunning for the manufacturing sector

SELLING HIGH-WAGE Germany to outside investors isn't an easy job these days. Unless, curiously enough, the investors come from low-wage China. In Hamburg alone, 42 Chinese companies set up shop last year, bringing the total in the city to 360 and feeding a miniboom in Chinese investment in Germany. Most are small shipping and trading companies. A growing number, though, are manufacturers seeking access to the European market, and they're even beginning to make acquisitions. "Germany is not as bad as people say," says Jiang Zhou, general manager of Welz Gas Cylinder, who praises the technical expertise of German workers. Welz, a maker of pressurized containers used for products such as fire extinguishers and beer kegs, was acquired in 2003 by China's Huapeng Trading, a Hamburg-based importer.

Why would businesspeople from China, with supercheap production and compliant workers, come to Germany, with its costly benefits and powerful

unions? For Huapeng, which already sells Chinese containers to European customers, the acquisition of Welz was an opportunity to provide quicker delivery and servicing, particularly in the high-end market. But it's also clear that the Chinese have another goal: acquiring patents and engineering expertise.

That's one reason why China's

TOOLMAKING
Weak companies may be at risk

Shenyang Ma Tool Group recently bought Schies maker of heavy

lathes and boring machines based in the East German town of Aschersleben. Shenyang can now draw on Schies' expertise to produce large equipment for the Asian market. "These are very complicated machines, and it takes years to acquire the expertise," says Schies' marketing Director Detlef Wolf. But Schies is already transferring production of server machinery to China. Such moves are helping boost China's modest but growing machinery exports to Germany, which last year topped \$1 billion for the first time, a 34% increase over 2003.

COPYCATTING

MORE SUCH DEALS are likely. Are Germans getting worried? Right. The country is desperate for investment to cut massive unemployment. So Chinese are welcome, especially if they have been mostly bottom feeders. Both Welz and Schies, for example, were bankrupt when acquired. "These companies have problems. The Chinese are saving them," says Welz's Jiang. China is also a huge customer for German products, especially machine tools.

But Chinese exporters are now taking Germany's low and middle market for capital goods. In high-end machinery, China lags by 5 to 10 years, says German Engineering Federation spokesman. "We see no direct danger, [but] industry should be alert," says Alexander Biele, an engineer who worked on the study.

The Chinese can also play rough. German salespeople have encountered exact replicas of their machines at trade shows. "For many Chinese companies, R&D consists of how to copy products," says Oliver Wack, an Asian manager at the Engineering Federation.

It would be a mistake to underestimate the Chinese, though. Chinese machine makers increasingly are supplying their home market, says Reinhard Geissbauer, a partner at Roland Berger Strategy Consultants in Munich, who thinks the market for German machinery in China has peaked. Germany can benefit immensely from Chinese investment in trade. But China will sooner or later become a sharp rival as well.

—By Jack Ewing in Frankfurt
with Dexter Roberts in Beijing

Two-Way Street

Germany still sells much more machinery to China than vice versa, but Chinese exports are gaining

GERMAN EXPORTS*	CHINESE EXPORTS**
2003 \$7.32 billion	2003 \$0.79 billion
2004 \$9.15 billion (+ 25%)	2004 \$1.05 billion (+ 34%)



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Social Security: Three New Ideas

As the national debate rages on, it's time for some fresh thinking

1 LET THE TRUST FUND INVEST IN STOCK INDEXES

THE PRINCIPAL economic idea behind President George W. Bush's proposal for private Social Security accounts is to tap the power of the stock market. After all, the Social Security Trust Fund consists solely of government bonds whose returns have historically lagged those of stocks. But there could be a better way to achieve the same goal: Keep the current setup but invest some of the Trust Fund in stock market index funds.

The notion, first proposed by President Bill Clinton in his 1999 State of the Union Address, was killed after running into opposition. But now that Bush has laid out his personal-account scheme, it looks increasingly as if the direct-investment approach would be cheaper and entail less risk.

"GOOD ECONOMICS"

OF COURSE, Bush's motives aren't just economic. Personal accounts are part of his broader philosophy of fostering a culture of ownership and personal responsibility. But the plan he proposed on Feb. 2 carries a host of restrictions, including no early withdrawals, only three stock-index funds and a bond fund to choose among, and strict limits on retirees' ability to take their earnings as a lump sum to spend or pass on to heirs. While these safeguards may be sensible ways to reduce the risk of individual investments in stock, they also gut much of the personal-ownership aspects of private accounts. So Americans would give up little if Social Security did their investing for them. "It's good economics for the Trust Fund to invest in stocks," says Massachusetts Institute of Technology

economics professor Peter A. Diamond.

One of the chief advantages of letting the Trust Fund invest is that it would offer a less risky way for Americans to play the stock market with their retirement money. Although the restrictions in Bush's plan reduce individuals' exposure to market volatility, they still would have to worry that stocks could crash right when they want to retire. It makes more sense to spread the risk over millions of Ameri-

cans, which would be the case if the Fund bought the stock instead.

Investing through the Trust would also entail sharply lower transaction costs. Look at what would happen the two different approaches. To private accounts, Washington have to sell up to \$2 trillion worth of bonds to cover payments to current retirees while workers divert a third of 12.4% payroll tax into their accounts. Borrowing would raise the federal deficit, although the Trust Fund would get the money back over 75 years as account holders retired. At that point, they would be gaining from their stock holdings while the fund would be paying lower Social Security benefits.

Direct investing, however, would let the Trust Fund invest in the stock market, slashing the transaction costs and the deficit, and leaving more money for Social Security beneficiaries. True, Washington also would have to issue new bonds, pegged at 3%. The bonds would be used for its stock buys to replenish the fund. But in this scenario, stock returns would immediately accrue to the Trust Fund, not individuals, say Diamond and others. So if stocks posted a 6.5% re-



social Security's equity
ings would earn 22%
after 10 years than the
now earns in bonds
early 50% more after
rs.

addition, administra-
verhead would be dra-
ally less without mil-
of individual accounts
nage. The cost under
ish plan would run to
30 basis points, the

House says. If all eligible Ameri-
et up accounts, the tab over 75 years
total \$425 billion in current dol-
according to University of Chicago
omics professor Austan Goolsbee. In
ast, Trust Fund investment would
one basis point, or just \$15 billion,
75 years, says MIT's Diamond.

OMATIC SWITCH

LE DIRECT investing would mean
g up the personal ownership of a
te account, the President's plan
s little to actually own. Sure, indi-
ls would have an account with their
on it, but they would be able to

Spread the risk, slash transition costs, and cut the deficit

choose only among the
three stock index funds and
the bond fund. Employees
couldn't withdraw any
money before their retire-
ment, even for a serious ill-
ness. And when employees
turn 47, the government
would automatically switch
their accounts into a "life
cycle portfolio" that is de-
signed to gradually shift
them from stocks to bonds

over the second half of their careers.

The Bush plan also limits how much
account holders could withdraw as a
lump sum when they retire. The Admin-
istration wants to make sure retirees don't
blow all their savings and wind up in
poverty. So Bush would require retirees to
buy annuities with their accounts suffi-
cient to keep them above the poverty line
until they die. This could leave as many as
half of all retirees with nothing left over to
take as a lump sum, since that's roughly
how many now depend on Social Securi-
ty to keep them out of poverty.

In other words, private accounts
would leave millions of Americans in
much the same place as their neighbor
who just stuck with traditional Social Se-
curity. The latter would get one monthly
check. Account holders would get two: a
smaller check from the traditional plan,
plus another that would put them ahead
or behind the neighbor depending on
how well their choice of index funds had
fared. Neither would have a pot of money
they could spend or will to their heirs.

POLITICAL TEMPTATIONS

CLINTON ABANDONED the idea of the
Trust Fund buying stock largely because
Federal Reserve Board Chairman Alan
Greenspan argued that it would pose too
much of a temptation for politicians who
might want to ban the government from
buying, say, tobacco stocks. But Bush's
plan doesn't ease this risk, since a new
government entity would manage and
run all private accounts. Even some pri-
vate-account advocates concede that it
would be just as easy for an activist Pres-
ident to purge the three indexes of tobac-
co stocks as it would if the Trust Fund
owned shares in the same indexes.

Investing part of America's retirement
assets in stocks may, in fact, be a wise idea.
But it might be more prudent and cheap-
er to spread the risk by letting Social Se-
curity do it—not through individual ac-
counts that many Americans will barely be
allowed to get their hands on anyway.

—By Aaron Bernstein in Washington

2 ADD-ONS COULD BE THE GREAT COMPROMISE

IN THE SOCIAL SECURITY debate,
Democrats are walking a fine line. They
don't want to oppose efforts to boost re-
tirement savings or help workers accu-
mulate assets—the popular features of
President Bush's private-account plan.
But Dems don't like his idea of weaken-
ing the safety net of government-paid
Social Security—or the borrowing re-

Beyond Bush-Style Accounts

Other ways to encourage
retirement savings:

BOOST 401(K)s Many more workers
would participate in these job-based
retirement plans if they were
automatically enrolled, with an opt-out

CHANGE TAX INCENTIVES Give
more generous tax breaks to
lower-income workers who participate
in retirement accounts

START KIDS SAVING EARLY The
government would hand every child, say,
\$500, which would go into an account
that must be held until retirement

quired to divert workers' payroll taxes
into the accounts.

So they are quietly starting to promote
an alternative known among Washington
wonks as "add-on" accounts. The idea: en-
courage workers to save more for their re-
tirement, without making any major
changes to Social Security itself. Like
Bush's private-account plan, add-ons fail to
fix the Social Security funding shortfall that
is expected in the future. Taxes would have
to be raised or benefits trimmed to do that.

But Democratic thinkers, such as for-
mer Clinton economic aides Peter R.
Orszag and Gene B. Sperling, back the
concept—first proposed by Clinton in the
late 1990s. No lawmakers have embraced
add-ons, however, and they get a strong
thumbs-down from most Republicans,
who want to salvage the President's plan.
Still, many observers believe add-ons
could be part of a final compromise in the
Great Social Security Debate. "If I could
get a pure add-on account while [reduc-
ing] benefit growth, I'd grab that deal in a
minute," says Urban Institute senior fel-
low Rudolph G. Penner.

Add-on backers have zeroed in on a se-



rious problem: Participation in retirement plans is dismally low, especially for low-income workers. Less than one-quarter of those making \$20,000 or less contribute to tax-deferred retirement plans; neither do almost half of those making \$20,000 to \$40,000. Among all income groups, a quarter of workers who are offered plans invest nothing, while only 5% contribute the maximum allowed. In 2001 (the latest numbers available) the median balance in 401(k) plans for workers 55 to 59 was just \$10,000.

One approach to boost participation in retirement savings would be to fund add-on accounts with tax hikes. Bush would let workers divert four points of their payroll tax into private accounts. With add-ons, workers would not shift any of their payroll tax. Instead, add-on accounts would be funded with other taxes, avoiding hefty borrowing.

Add-ons could also be structured as enhancements to today's individual retirement accounts and 401(k)s. Some Democrats would make enrollment in 401(k)s automatic for eligible workers unless they opt out. Some companies that tried that saw participation double. Another idea: change tax breaks for savings so they benefit lower-wage workers rather than their better-paid colleagues. Replacing deductions with credits could help lower-income workers save new money. Also, the feds could create universal, government-funded savings accounts. Senators from Joseph I. Lieberman (D-Conn.) to Rick Santorum (R-Pa.) would grant every child a lump sum at birth to start a retirement account.

Democrats and advocates for the elderly love add-ons. But the politics are dicey. Bush could boost his chances of getting a bill through the Senate by accepting the idea. But he'd risk losing GOP votes in the House. Conservatives might be willing to cut promised Social Security benefits if, in return, they could also shrink workers' dependence on Big Government. But they'll be reluctant to back such cuts if Social Security is left intact.

For Bush, the choice is different. Add-on accounts are a long way from his vision for Social Security. But they might be his only path to a signing ceremony in the Rose Garden.

—By Howard Gleckman in Washington

3 USE AFTERTAX INDEXING, NOT PRETAX

SINCE 1979, Social Security has offered the best protection against inflation of any pension plan in existence. First, benefits for existing retirees are bumped up enough each year to compensate for any increase in consumer prices. Nobody is talking about changing that.

More important, the initial benefits for a new retiree are determined in part by the overall level of wages in the economy today, not just by the person's past earnings. If overall wages rise by 6%, the Social Security formula is tweaked so that initial benefits rise by 6% as well. If wages go up by 1%, so do initial benefits. This adjustment process, called "wage-indexing," allows the living standard of new retirees to keep up with the living standard of the working population.

In his State of the Union address, President Bush floated the idea of getting rid of wage-indexing and tying initial benefits to prices instead. This seemingly technical change was vehemently attacked, and for good reason: Under this proposal, the real value of benefits would stay fixed over time, even as real wages for workers rise. Enormous sums would be saved, but retirees dependent on Social Security payments would fall further behind the working population.

There's a way the indexing formula can be changed to cut costs and also be fair to both retirees and workers. Under today's law, initial benefits are linked to pretax wages. A better option is to tie initial benefits to an appropriate measure of aftertax wages.

Aftertax indexing, while not part of the current policy debate, has several advantages.

Aftertax wages are a better gauge of the true buying power of workers. In the long run, aftertax wages are also likely to grow slower than pretax wages, since economists expect the tax burden on workers to rise sharply as the boomers retire. As a result, initial benefits, which today are linked to pretax wages, will probably significantly outpace the living standards of workers, who will depend on aftertax wages.

BIG BUCKS

HOW BIG A difference would this switch to aftertax indexing make? There are many possible approaches that could be used to answer this question, but one calculation done by *BusinessWeek* suggests that the benefit for new retirees would rise by roughly 0.2 to 0.3 percentage points less than pretax wages each year. Under this policy, tying benefits to aftertax wages, someone who retires in 2080 will receive about 14% less than under the current system. By comparison, the proposal that President Bush mentioned in his speech would call for a benefit cut of more than 50% in 2080.

Here's how the calculation for aftertax indexing is done. Today, the payroll tax for Social Security and Medicare together equals 15.3%, including employer and employee contributions. In 2080, the tax burden on a worker will be supporting almost twice as many beneficiaries as today, according to the Social Security Administration. That suggests the corresponding burden on workers should rise to keep pace with the increased number of beneficiaries, pushing the tax burden up about 27% by 2080. This money could either come from higher payroll taxes or additional income taxes.

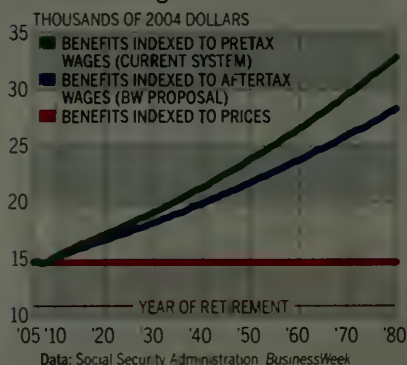
This higher tax burden sharply affects aftertax wages. According to government projections, pretax real wages are expected to rise by about 1.1% per year over the next 75 years. But taking the rising cost of Social Security and Medicare into account, aftertax wages rise by an average of only 0.9% per year. This small yearly difference adds up to big bucks over time.

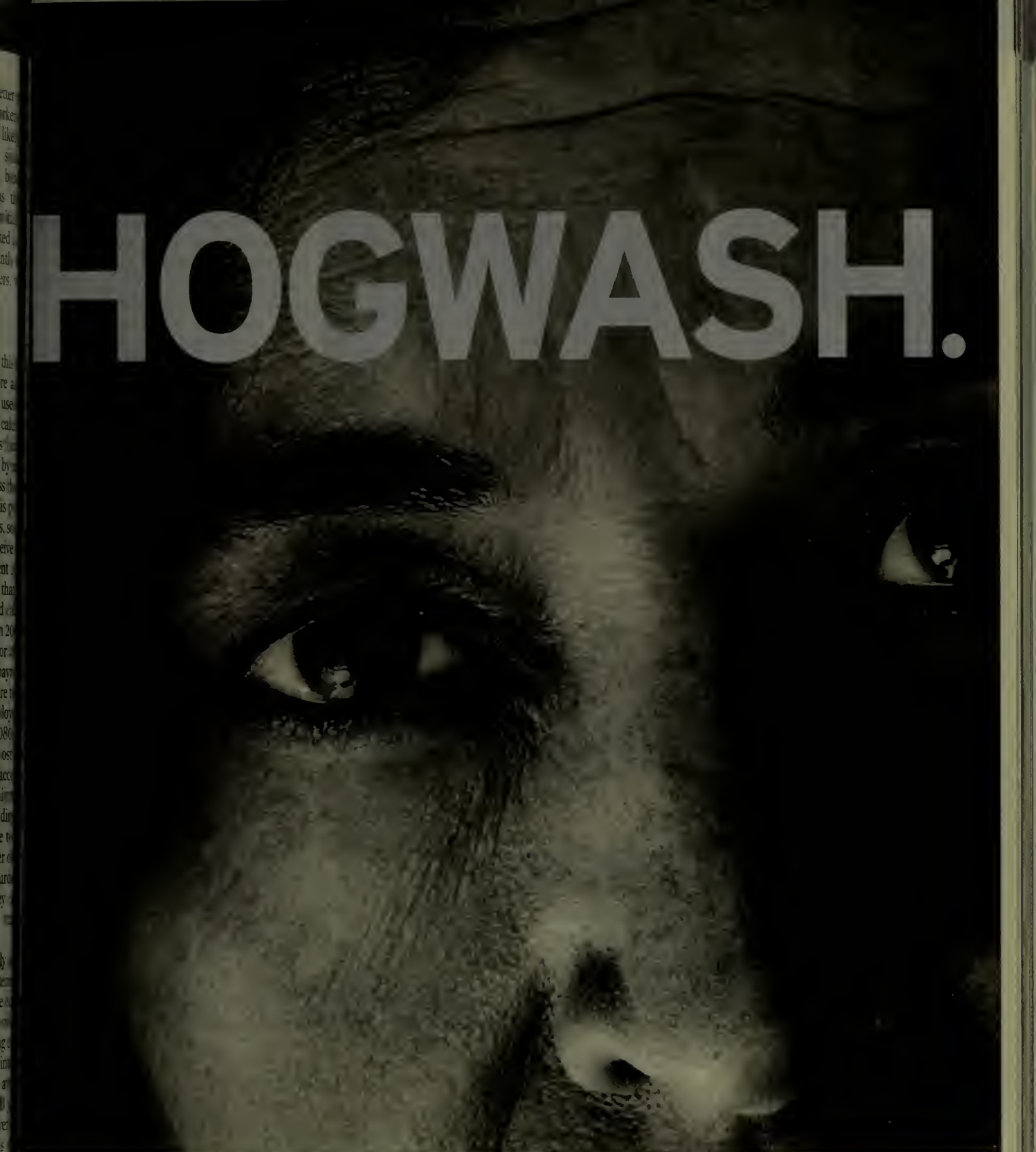
Far more detailed calculations of the effect of aftertax indexing could include factors such as personal income taxes and Medicare premiums for retirees. The upshot is the same: If benefits stay tied to pretax wages, the economic position of new retirees will get better relative to workers, and that could lead to a backlash. Indexing by aftertax wages will solve all the financial problems of Social Security. But it's the right way to fairly share the burden. ■

—By Michael J. Mandel in New York

WHY INDEXING MATTERS

Initial Social Security benefit for the average worker reaching retirement age





HOGWASH.

Some people think building wealth is easy. Hardly the case. Your Smith Barney Financial Consultant knows it takes a lot of elbow grease, sound advice and dedicated teamwork. You've worked hard to get where you are. You can expect no less from us. Visit us at www.smithbarney.com to find out more.

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SMITH BARNEY
citigroup 

KELROY Medicaid pays the nursing home fees of the retired postmaster

The New Face Of Medicaid

Seniors and the disabled are pushing the program to the breaking point

AT 90, CECILIA KELROY has the honest eyes and kindly Midwestern look you'd expect of the former postmaster of Mundelein, Ill. She's also the new face of Medicaid. Kelroy moved into a nursing facility after suffering a stroke in 1998. By 2001, her \$150,000 nest egg eviscerated by expenses, she went on Medicaid. Now she lives in a nursing home in the Chicago

suburb of Libertyville, and this year the federal-state program for the poor will pay \$36,135 for her care.

Founded in 1965, Medicaid was long thought of as a safety net for poor mothers and their children. Low-income families and young adults still dominate its rolls, making up about 40 million of the program's 53 million participants. But these days two-thirds of Medicaid funds are spent on seniors and the disabled, mostly for long-term nursing care.

Now, the Bush budget released Feb. 7 proposes to trim Medicaid spending by about \$60 billion over the decade—the biggest single cut in President's drive to halve the deficit in his second term. Governors are bracing for battle. Their fear: Medicaid costs already 22% of state budgets and what they spend on higher education will skyrocket. Health-care providers and patient advocates are struggling to figure out where the program is headed. The Administration manages to shift most responsibility onto statehouses.

Underlying today's debate is the central question of how Medicaid can sustain itself as it shifts from funding medical care for the young poor to providing custodial care for the elderly and disabled. Already Medicaid's seniors claim 26% of the program's budget—\$48 billion in 2003, even though they make up just 9% of Medicaid rolls (chart). The disabled—including the mentally ill and those suffering from debilitating chronic diseases or developmental disabilities—represent 16% of Medicaid rolls but take 43% of Medicaid's funds. The program will cost \$80 billion in 2003.

EXTRA LEEWAY

MEDICAID ALREADY PAYS more than 60% of the nation's total tab for nursing homes, vs. just 5% paid by Medicare. The government's medical insurance plan for the elderly. As more seniors join the program, costs will rise more rapidly. For seniors and the disabled average more than \$12,000 annually per person while caring for a child or young adult costs less than \$2,000. And as the 40 million baby boomers age, their growing demand for nursing care threatens to crowd out Medicaid's original mission of serving impoverished mothers and youngsters.

The White House acknowledges the demographic reality and is responding with more flexibility. For example, Medicaid routinely picks up nursing-home bills for those poor enough to qualify but not at paying for assisted living or home health care. Dr. Mark B. McClellan, administrator of the federal Centers for Medicare & Medicaid Services, says the Administration will change that. "We shouldn't have an institutional bias in the program," he says. "Many people can get services in their community at a lower cost."

Health experts praise the White House's tilt toward flexibility—but warn it won't save much money unless states raise the level of care for those elderly who stay at home. Wisconsin, for instance, has already begun a program to assist such seniors. "It's making people feel better about

elves," says Mark Moody, Medicaid administrator for Wisconsin's Division of Care Financing. "[But it] isn't necessarily saving us more money."

Administration also hopes to save out \$100 million in annual savings by cracking down on what it sees as abuse in the system—middle- and wealthy seniors who transfer assets to relatives, impoverish themselves, qualify for Medicaid to pick up their long-term care bills.

States are already acting. Many, including Virginia, plan to examine six years of financial statements for Medicaid applicants to weed out the current flood of evidence of asset-gaming. After years of being neglected, others are beginning to enforce the laws on the books.

Young baby boomers are not only going to put enormous pressure on Social Security and Medicare but could overwhelm Medicaid as well.

That's why the White House wants to use tax breaks and other incentives to encourage seniors to buy long-term-care insurance to pay for their own old age. So far, policies—costly and complicated—have been slow to catch on. But Medicaid will never be able to support the costs for those 40 million boomers.

Proposed changes in the care of the elderly and disabled are only one part of a major shift in the financing of the program—a step that could radically alter the way millions get their long-term care. In addition to his rather modest budget proposals, Bush is offer-

ing states a trade-off. Governors could escape the current complex regime of federal rules and get broad leeway to run Medicaid programs. In return, states would have to accept a cap on federal funding for all but the poorest participants. Says McClellan: "I'd like to see us focus on more effective use of the dollar by giving states flexibility." With a fixed annual contribution, Washington would shift additional risk to states, which could save money by delivering services more efficiently—or by providing less care. But they would bear the burden of unexpectedly high costs.

That would put tremendous pressure on states to operate the program for less. Some governors, including Jeb Bush of Florida, seem willing to make such a trade. But most state officials fear that the swap could become a multibillion-dollar bait and switch. "The risk is they are not serious about flexibility," says Iowa Governor Tom Vilsack, a Democrat. "All they'd be doing is forcing states to cut benefits" and trim the Medicaid rolls.

Already, states are scrambling to cut costs. "States are under incredible pressure," says John Holahan, director of the Urban Institute's Health Policy Center. A survey by the Henry J. Kaiser Family Foundation found that 47 states are cutting or freezing payments to doctors and hospitals this year: 43 are lowering drug costs, 15 are making it tougher for low-income people to enroll in the program, 9 are cutting benefits, and 9 are increasing patient co-payments. The survey also

found that 17 states have targeted long-term care for cuts, either by trimming payments to nursing homes or slashing enrollments.

The most dramatic changes are coming in Tennessee. Its TennCare program was widely considered the most generous state health program in the nation. But costs have outrun revenues, and after years of battling over whether to hike taxes, the state is throwing in the towel. In January, Governor Phil Bredesen, a Democrat, said Tennessee would limit eligibility for the program and cut benefits for those who remained. Health-care advocates estimate that as many as 323,000 adults could lose coverage.

Governors are also struggling with another troubling trend: Waves of low-wage workers are applying for Medicaid because they don't get insurance from their employers. A new Massachusetts study reports that the state spent \$52 million in fiscal 2003 to care for 27,000 workers and their dependents at more than 130 companies, including Wal-Mart, Dunkin' Donuts, and Stop & Shop. The companies say many of these workers were part-timers or new employees who didn't qualify for employer coverage. And Wal-Mart points to a new survey showing that while 5% of its hourly workers are on Medicaid, 7% were using the program before joining the company.

In the short run, young workers and their families will continue to be a problem for Medicaid. But policymakers in Washington and in state capitals increasingly have their eye on the looming cost of caring for the elderly and disabled. And time is on nobody's side. ■

—By Howard Gleckman in Washington, with Ann Therese Palmer in Libertyville, Ill.

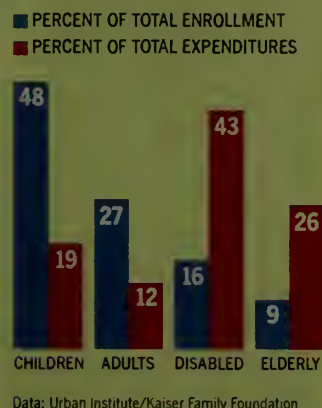
Looming: A crackdown on middle-class seniors who abuse the system

COSTS EXPLODE...



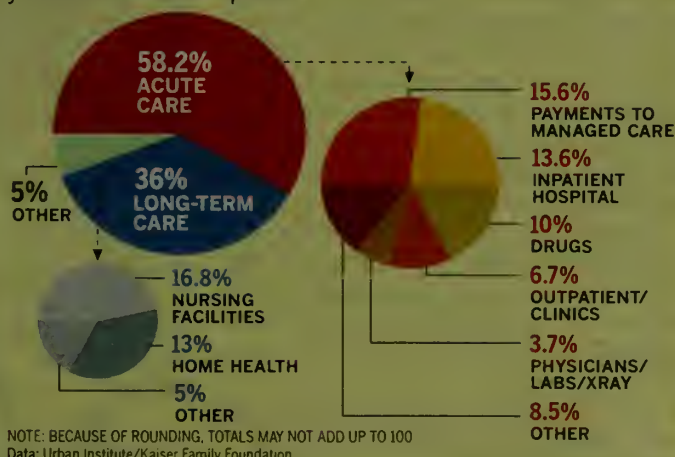
...WHO BENEFITS...

More than 50 million people are enrolled in Medicaid. How the benefits break down:



...AND WHERE THE MONEY GOES

Medicaid shells out \$300 billion each year. Here's how it's spent:



Dressed To Kill... Competitors

Southwest's new boss is taking aggressive steps to boost capacity and profits

GARY C. KELLY IS A steady, mild-mannered former accountant. But don't let that fool you. The new 49-year-old chief executive of Southwest Airlines Co. is also spearheading some of the most aggressive moves that the low-fare king has made in years.

Since taking over at Southwest last July, after the sudden retirement of James F. Parker, the Porsche-driving former chief financial officer has accelerated the company's attacks on struggling high-cost competitors and undermined long-held beliefs about how Southwest will compete. Kelly's boldest move: the acquisition of six gates at Chicago's Midway Airport from bankrupt ATA Holdings Corp., and the signing of Southwest's first alliance with another airline. That followed Kelly's vigorous attack on the federal law that limits Southwest's flights from its home base at Dallas Love Field. In doing so, Kelly ditched a decades-old policy of "passionate neutrality" toward the restrictions and created a direct challenge to American Airlines Inc.'s nearby hub at Dallas-Fort Worth International Airport. Analysts and competitors marvel at the newfound moxie. "This is a different Southwest. They've always jumped on opportunities. We've just never seen them this jumpy," says Darryl Jenkins, a visiting professor at Embry-Riddle Aeronautical University.

The youthful and energetic Kelly is a good fit for the Southwest image. "Gary brings a lot more of a 'change agent' element here" than his predecessor, says one insider. That was abundantly clear at last year's Halloween party, when Kelly shocked co-workers by showing up as Gene Simmons, front man for the rock group Kiss.

Perhaps Kelly, who joined Southwest as its controller in 1986, has simply figured out that no one was buying the airline's old "Aw, shucks, we're just an underdog" act anymore. Says America West Airlines Inc. CEO W. Douglas Parker: "They really were at one point the scrawny kid who was lifting weights in his basement. Now they come out and they're bigger than anybody else and stronger than anybody else." In fact, Southwest now carries more domestic passengers than any other U.S. airline. For his part, Kelly insists there's nothing different about Southwest's behavior: "We've always been a growth airline, and have always been a maverick, and have always been very competitive."

The difference now is that Southwest, with the lowest costs and the strongest balance sheet, appears to be permanently shifting the balance of power to low-cost



THE TWO FACES OF CEO KELLY He showed up at a company party as Gene Simmons, but adding six gates in Chicago was far gutsier

carriers. So it should come as no surprise that Southwest is on the offensive. It plans to increase capacity at least this year, adding 29 planes to its fleet of 417. Like other airlines, it hunkered after September 11 and the crippling recession that brought four years of try losses. Southwest grew by just 2003. But with travel improving, it's seeing opportunities as big competitors struggle to return to profitability in the face of costly fuel and shrinking fares.

"GROWTH OPPORTUNITIES"

YET SOUTHWEST'S game plan is aggressive, as well. Its 2004 earnings of \$1.1 billion were just half what it earned in 2000. Without financial hedges, Southwest would have lost money in three of the eight quarters. The best way to improve future returns, says analyst Gary C. Lehmman Brothers Inc. in a research report, is for Southwest "to take advantage of the growth opportunities created by industry duress." That's now important cause formidable low-cost rivals,

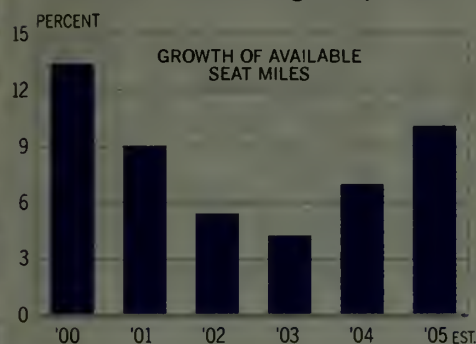


TAILWIND
Kelly's ATA
deal extends
Southwest's
reach

GAINING ALTITUDE

Southwest is accelerating its expansion...

...and trying to leverage its cost advantage



Data: Southwest Airlines Co., Unisys R2A

	CENTS	UNIT COSTS*
SOUTHWEST	7.77	
AIRTRAN	8.59	
JETBLUE	9.52	
AMERICA WEST	9.77	
AMERICAN	13.90	
NORTHWEST	14.10	
CONTINENTAL	14.38	
UNITED	14.61	
DELTA	15	
US AIRWAYS	16.83	

*COST PER SEAT FLOWN A MILE IN THE U.S., ADJUSTED TO SOUTHWEST'S AVERAGE FLIGHT LENGTH FOR YEAR ENDED SEPT. 30, '04

AirTran Airways and JetBlue Airways are eager to grow in the same markets Southwest is targeting. They can promote arguably better seats, including assigned seats, business, and seat-back televisions. Southwest is rushing to stake its claim in places like Philadelphia and Pittsburgh, now dominated by bankrupt airlines. US Airways and hub-and-spoke giants are working hard to survive by slashing labor and other costs. They're still a long way from matching Southwest, but some are likely to emerge much nimbler. Southwest's healthy expansion to help keep its unit costs under control. It boasts the lowest wages for pilots of narrow-body jets, 38% above those at United Airlines after that carrier's deep pay cuts. By 2005, Southwest averages in new, low-cost employees and spreads its costs over more seats. At the same time, it is pushing for higher productivity from its already highly efficient workers. Southwest's pilots say they're being asked to fly 70 hours a month, up from about 65. Pilots at the traditional carriers average less than 60.

Perhaps no Southwest move stunned the industry more than its December deal to link up with rival discount carrier ATA. For \$117 million, Southwest got six more gates, bringing its total to 25 of Midway's 43. It also will get a 27.5% owner-

ship stake, which it says it will unload over time. And in a move previously unheard of for Southwest—except for an experiment with Icelandair in 1996—it is code sharing with ATA, which means it will market tickets for some of its flights. Southwest's customers can easily connect with ATA to such cities as Boston, Denver, Minneapolis, and Honolulu. Southwest also gains precious access to New York's LaGuardia Airport and Ronald Reagan Washington National Airport.

SHAKING THINGS UP

NOT INCIDENTALLY, Southwest's deal locks up Midway, some rivals contend. AirTran and America West each wanted all 14 of ATA's Midway gates to create a viable hub there. Now, even if ATA dies, they might find that impossible to do. Indeed, ATA has pulled out of most routes where it was competing with Southwest from Chicago. "They've kind of carved up the market," says Robert L. Fornaro, president of AirTran Airways Inc.

Southwest seems equally determined to remain the dominant low-fare carrier in Dallas-Fort Worth. With Delta Air Lines Inc.'s recent dismantling of its hub at DFW International Airport, Southwest considered starting operations there that would be unfettered by the so-called Wright Amendment. That 1979 federal law, amended in 1997, limits Southwest's flights at Dallas Love Field to Texas and seven other nearby states. But rather than split its operations in Dallas or abandon its longtime home, Kelly is calling for repeal of the law, which was meant to protect a fledgling DFW airport. "Every member of Congress that I've talked to agrees that it's a bad law," says Kelly. Repeal could free up more than \$500 million in potential revenue for Southwest, figures analyst Chase.

How much of the recent aggressiveness—or "assertiveness," as they

prefer at friendly Southwest—reflects new opportunities or a new boss is the subject of much debate. After all, company co-founder and Chairman Herbert D. Kelleher, 73, is still firmly in charge of strategy and route plans, as he was when Parker, a reserved lawyer, was CEO. "We just didn't have these kinds of opportunities in 2002 and 2003," says Kelly.

But Kelly has been shaking things up inside the company, too. One of his first moves was to realign his management group to improve accountability and cooperation between departments. And while Southwest has long been known for its warm labor relations, those relationships were frayed during Parker's bitter contract negotiations with flight attendants. Feeling demonized by union leaders, Parker turned the job over to Kelleher, who reached a richer-than-expected settlement. Parker retired soon afterward, citing "personal reasons," but many believe the contract dispute was a key factor. Kelly created a new department focused on labor relations and now meets quarterly with union leaders to discuss finances and strategy. He's also insisting that all employees get regular scorecards on productivity and profitability measures.

For all of the changes, Kelly hasn't yet introduced such complications as international flights or the use of smaller regional jets, a move planned by JetBlue. He's even cautious about assigning seats, a service that new technology would easily allow but that many passengers, believe it or not, have said they would detest. But if Kelly's early months in office are any indication, Southwest is sure to keep rocking the industry. ■

—By Wendy Zellner in Dallas

BusinessWeek online For an interview with Southwest CEO Gary Kelly, go to www.businessweek.com/extras

Can Cisco Settle for Less Than Sizzling?

Beset by fierce rivals, it faces a choice others would kill for: Chasing either fast growth or high margins

JUST A COUPLE OF YEARS ago, Cisco Systems Inc. seemed like an unstoppable force in the tech industry. Every trend pointed toward the rise of the Internet technology that was the company's specialty. Telephone companies, cable-TV providers, and cellular companies all were planning to replace their aging networks with cheaper, more powerful Net technologies. Ask a Cisco executive why the company didn't buy its way into telecom by acquiring the beleaguered equipment makers Lucent Technologies Inc. or Nortel Networks Ltd. two years ago, and the answer was predictable: As Executive Vice-President Michelangelo Volpi put it in 2003, "What would we get out of it? Their technologies are not relevant to what customers want." The

world, it seemed, was moving Cisco's way.

But it hasn't been that simple. While the migration to Net technology is proceeding apace, the opportunities for Cisco are turning out to be more elusive than it first seemed. Since plunging into one new market after another, Cisco finds itself in a multifront war against a range of surprisingly feisty rivals. Little-known competitors like Brocade Communications Systems Inc. and F5 Networks Inc. go toe to toe with Cisco in some markets, while the recovering Lucent and Nortel are waging fierce battle in others. Even in corporate networking gear, its traditional stronghold, Cisco is facing its most serious competition in a decade from China's Huawei Technologies, Silicon Valley's Juniper Networks, and others.

All of this is starting to take its toll on the San Jose (Calif.) giant. The company

had stellar results in 2004: Sales rose 17%, to \$22 billion, while net income rose 24%, to \$5.3 billion. But Cisco's struggles in so many of its new markets raise questions about whether this is the end of its heyday. On Feb. 8, it reported that for its most recent quarter increased to \$6.1 billion, slightly short of Wall Street estimates. Many analysts think that will be the first step in a marked slowdown in both revenue and profit growth, possibly to 10% over the next two years. The company's stock has dropped 39%, to its lowest level since the beginning of 2004.

"PAINTED INTO A CORNER"

CISCO, IT SEEMS, is stuck in a strategic box. It can pursue either growth or profit, but not both. Although Chief Executive John T. Chambers recently laid out a plan to boost revenues as much as 15%

Cisco's Challenge

Cisco is struggling to retain its highflier status. With competitors coming on strong, it may be difficult to meet CEO John Chambers' goal of boosting revenues 12% to 15% a year through 2008.

CORPORATE NETWORKING GEAR

Cisco has 70%-plus of the \$20 billion market, which makes up nearly 70% of its revenue. But low-cost producers, especially China's Huawei Technologies, are on the march. To stay ahead, Cisco may have to add features such as security software, without raising prices.

COMMUNICATIONS EQUIPMENT

When phone and cable companies began to buy Internet-style gear, Cisco looked set to be a major player in this \$50 billion market. It hasn't happened. Telecom vets like Alcatel and upstarts like Juniper got in fast. Cisco remains a bit player, with about a 5% share, estimates Synergy Research.

INTERNET PHONE SYSTEMS

The market is set to zoom from \$3.5 billion now to \$10.5 billion in 2008. Pioneer Cisco had 40% two years ago. Now it has 23%—behind Lucent spin-off Avaya's 25%. Many companies prefer suppliers such as Avaya and Nortel, whose gear can be installed more gradually.

NETWORK SECURITY

Cisco leads the market for keeping corporate networks virus-free. But rivals are fierce—AT&T, Juniper, Microsoft, and specialists such as Checkpoint Software. That's holding down prices, resulting in a market that's expected to grow from only \$4.1 billion in 2004 to \$5.9 billion in 2007.

CONSUMER ELECTRONICS

Cisco has a huge success with its Linksys, nearly doubling sales to \$800 million. But hot competition from NetGear and D-Link makes this a low-margin business. Bottom line: Cisco's push into consumer gear looks unlikely to add much to revenues or profits.



CHAMBERS

Enough bang for \$3 billion in R&D spending?

year until 2008, it now looks as if Cisco may fall short of that mark unless it takes drastic action.

It can target new markets and slash prices in several markets to grab market share and boost the top line. But that would wreak havoc on Cisco's rich margins, which averaged 68% last year. With \$16.5 billion in cash, it could also pursue more and larger acquisitions. But again, that's likely to come at the cost of the company's profits. "Cisco is a phenomenally well-managed company, but I think they've painted themselves into a corner," says David J. Eiswart, who manages networking investments for T. Rowe Price Group Inc. "Having 68% margins means you're in the high-tech equivalent of the diamond business, and there are only so many diamond mines out there."

One possibility: Give up the hunt for the next mine. Cisco could let go of the notion that it's a hot-growth company and start acting like its big-cap brethren. Some analysts and investors think Chambers & Co. should accept lower revenue growth and lure investors with steady cash flow and even—gasp!—dividends. "There's nothing wrong with being the market leader and making a ton of money," says analyst Samuel C. Wilson of JMP Securities LLC.

REVENUE QUEST

THIS IS SIMPLY heresy to Chambers and his lieutenants. The CEO contends that Cisco can thread the needle, balancing speedy growth with healthy profits. At a December analysts' conference, Chambers and his top brass walked through a detailed explanation of how Cisco could grow 12% to 15% a year through 2008, while maintaining 65% gross margins. The plan calls for reigniting growth in its core markets, selling corporate routers and switches, and then marketing those products with a broad swath of related technologies, from \$79 wireless routers for the home to consulting services for companies. "We believe we are not only well-positioned to compete, but to lead," Chambers said at the conference.

Still, the math doesn't look as if it adds up. To reach the 15% annual growth target, the number investors are really looking for, Cisco would have to increase revenues from \$22 billion last year to \$38.5 billion in 2008. Cisco predicts that sales to its core markets will rise about 11% annually, but some industry analysts say the more likely figure is just 9%. That means Cisco will have to come up with roughly

\$7.5 billion in incremental sales from its emerging businesses.

Is that figure attainable? Chambers may have to take the gloves off. Consider the market for the equipment that corporations use for Internet telephony. Cisco helped pioneer the field and held a 40% share just two years ago. But since then, little Avaya Inc. has surpassed Cisco as the market leader, swiping a 25% share and pushing Cisco down to 23%. CEO Donald K. Peterson says he's lucky to have Cisco as a competitor because it refuses to undercut him on price. "It's not because they are nice people," he says, "but because their market value requires them to hold their margins."

LOUD GROANS

AS IT COMPETES IN SO many markets, Cisco has struggled to stay on the front edge of innovation in all of them. One example: wireless networks for corporations. Cisco leads the market, but upstart Airespace Inc. has gained loads of share over the past year because its products are easier to use and install. The result: In January, Cisco agreed to pay \$450 million for Airespace, which was on track to do \$85 million in sales in 2005, say insiders. That prompted groans from some investors who believe that Cisco should be getting more of an edge from the \$3 billion it spends on research and development. "It's kind of pathetic," says a portfolio manager at one of the company's largest shareholders. "It seems like something is broken at Cisco."

Cisco has had a number of successes in the new markets it has targeted. It be-



came the market leader in home networking products after acquiring Linksys Inc. in early 2003. It also has become a leading provider of network security products. Sales of its advanced technology products surged 40% in the most recent quarter.

And Cisco vows to keep diving into new markets. Chambers told analysts in December that Cisco would soon unveil four more initiatives that it thinks could eventually become \$1 billion businesses. *BusinessWeek* has learned that these will include network management software to help companies make more efficient use of their computers and storage gear, and applications for Internet telephony, such as videoconferencing. Goldman, Sachs & Co. analyst Brantley Thompson said in a

PETERSON Avaya beat out Cisco for leadership in Internet telephony

report that a third new line will be video-on-demand service for cable and phone companies.

Even if Cisco gains share in these businesses, the real question is whether it is gaining enough to make a difference for a \$22 billion company. Take the market for storage networking, specialized switches that direct the data flow between storage system servers. When Cisco entered the \$1.3 billion market in 2003, most analysts figured it would quickly swamp smaller competitors such as Brocade Communications. Brocade was concerned that it hired a platoon of high-priced executives and hosted a \$100,000 golf tournament to buff up its brand could have saved its money despite investing more than \$100 million, Cisco has sold \$200 million of its switches,

dubbed Andiamo. That gives Cisco 17% of the market, compared with Brocade's 47%. The reason: Most customers are loath to risk their data if their current technology is working. "Cisco is a formidable customer, but you can't underestimate the value of a happy customer," Brocade CEO Michael Klayko.

The most disappointing performance has been in the market with the most potential: telecom. Phone companies spend about \$70 billion a year on capital expenditures, and a rising percentage of that money is going towards Internet technology that will help telecom companies offer voice, data, and video services to customers. Yet Cisco has nabbed a mere 5% of the market—far short of the goal Chambers set a few years ago. The big reason is that fast-rising Juniper Networks is making off with a chunk of the business. Cisco expects to start regaining some share in the market for the large routers. During its Feb. 8 earnings call, it said it had 12 paying customers for its recently introduced, \$500,000 CRS-1 router; another 12 are evaluating it.

Even so, Cisco may find rising competition from traditional phone company suppliers. Lucent and Nortel were teetering on the edge of bankruptcy a few years ago, but they've since regained their footing and have developed their own efficient equipment based on Internet technology. They're also willing to accept lower margins than Cisco. Alcatel, for example, is an industry leader in selling digital subscriber line multiplexing (DSL) equipment—broadband gear that typically

Should Cisco Start Hunting Big Game?

With \$16.5 billion in cash and a \$116 billion market cap, Cisco could buy almost any company it wanted. Its execs insist they'll stick to startups. But Cisco may need bigger prey. Some possibilities:

NETWORK APPLIANCE The most likely big deal. This would give Cisco the fastest-growing competitor in the surging \$20 billion storage market. The downside? NetApp is pricey, with an \$11 billion market cap, and the synergies are questionable.

EMC Buying the resurgent behemoth of storage would give Cisco an even more overwhelming influence over the world's corporate buyers. But with a market cap of \$32 billion, EMC is expensive, and a deal would create management headaches.

BROCADE The leading supplier of low-end storage networking switches, Brocade has maintained its share since Cisco entered the market in 2003. Rather than hurt margins for both companies, Cisco could buy Brocade while it's still profitable.

NORTEL The most intriguing long shot. Nortel is mired in an accounting scandal and boardroom intrigue. Yet it remains one of the top suppliers to the world's telecom companies, a huge market in which Cisco has struggled to grab share.

COMMENTARY

BY BRIAN HINDO

Not So Fast, Mr. Mayor

Is a new stadium critical to New York's Olympics bid?

WHEN REPRESENTATIVES of the International Olympic Committee visit New York City on Feb. 21 to evaluate its bid for the 2012 Summer Games, they'll get the red-carpet treatment, a guided tour, and glimpses

ply using that threat to get the stadium approved in a hurry—and then, if New York doesn't win the Olympics, well, they still have the stadium? A spokesperson for the IOC who doesn't wish to be named says that "it's the quality and totality of the bid" that counts, not any specific venue. In fact, Paris—which many consider the favorite—features a 20-year-old stadium as the core of its proposal.

The project is already beset by two lawsuits, and media behemoth Cablevision Systems Corp., which owns nearby Madison Square Garden, is maneuvering to kill the deal. Even if the stadium wins approval, some critics say it's actually a detriment to New York's bid. Why? In short, the arena adds too much complexity, cost, and controversy, argues Brian Hatch, former deputy mayor of Salt Lake City, the last U.S. city to host the Olympics. Doctoroff says the city has investigated every other site and that "we have no alternative."

The New York plan has undeniable merits. The proposed stadium is a stunner, and Doctoroff's advance planning might come as a relief to the IOC, which nervously watched paint dry as the Athens Games began last summer.

That's why Ed Hula, editor of Olympics newsletter aroundtherings.com, pegs New York as a close second to Paris. Still, "it seems like a risky choice to hang the bid on the stadium," Hula says. "It's not traditional for a city to throw down a gauntlet like this." But, hey, chutzpah is what New York is all about. ■

—With Jack Ewing in Frankfurt



of a new citywide ad campaign. What they won't see is the centerpiece of the bid: a \$1.4 billion arena to be built over a rusty rail yard on the Hudson River. The proposed New York Sports & Convention Center—the most expensive stadium ever—would house the New York Jets football team.

Politicians and community activists opposed to the stadium call it a gift to the Jets. Mayor Michael Bloomberg and Deputy Mayor for Economic Development Daniel L. Doctoroff—a former investment banker and the driving force behind New York's 2012 bid—call it crucial to landing the Olympics. They warn that if the stadium isn't approved before the IOC decides among finalists London, Madrid, Moscow, New York, and Paris on July 6, then the Big Apple's chances are sunk. Says Doctoroff: "[The IOC] wants to know that we're going to be able to deliver."

But are Bloomberg and Doctoroff sim-

DAZZLING An artist's rendition of the proposed arena on the Hudson

gross margins of less than 50%. Many investors believe Chambers to take more decisive action to slash Cisco's hot-growth credentials. One possibility: a big acquisition. He says it isn't interested in big deals and will stick to buying hot startups. Yet its market cap of \$130 billion and \$6 billion in cash, it could afford to buy any company. Potential targets range from Avaya to all or part of Nortel. The problem with most acquisitions, however, is Cisco's margins. If it buys a company that gets less profit per dollar of revenues, the combined margins will fall and many investors will punish Cisco's stock. Asked if he thought Cisco would knock on his door, Avaya CEO Peterson says he isn't holding his breath. "Our corporate margin is 48%, and theirs is 68%. The arithmetic does not work," he says. "That's why I don't think they can do a buy without resetting their earnings expectations."

There's one oft-whispered target that is an exception to the margin problem: Network Appliance Inc. A fast-growing star in the surging storage market, the Sunnyvale (Calif.) company is growing more than 30% a year and had gross margins in its most recent quarter. But NetApp's success presents a real problem. Cisco's price-earnings ratio has dropped to 24, compared to 67 for NetApp. That means that Cisco's market value, which is now \$11 billion, would only be worth \$4 billion if investors started valuing its earnings at Cisco's p-e. NetApp CEO Daniel J. Green says there have been discussions with Cisco.

During the Feb. 8 earnings call, one analyst asked Chambers why it is that Cisco believes Cisco will be able to avoid a loss of large numbers, which has been slowing revenue growth at every company as it grows in size. Chambers gave an expansive explanation, suggesting that Cisco may be difficult because the networking products it sells increase in value as more and more customers have them. "This may be the only industry where it isn't as simple as the law of large numbers," he says. "Let me give you the opportunity to challenge our thought process on this. What's one more challenge in the industry to come?" ■

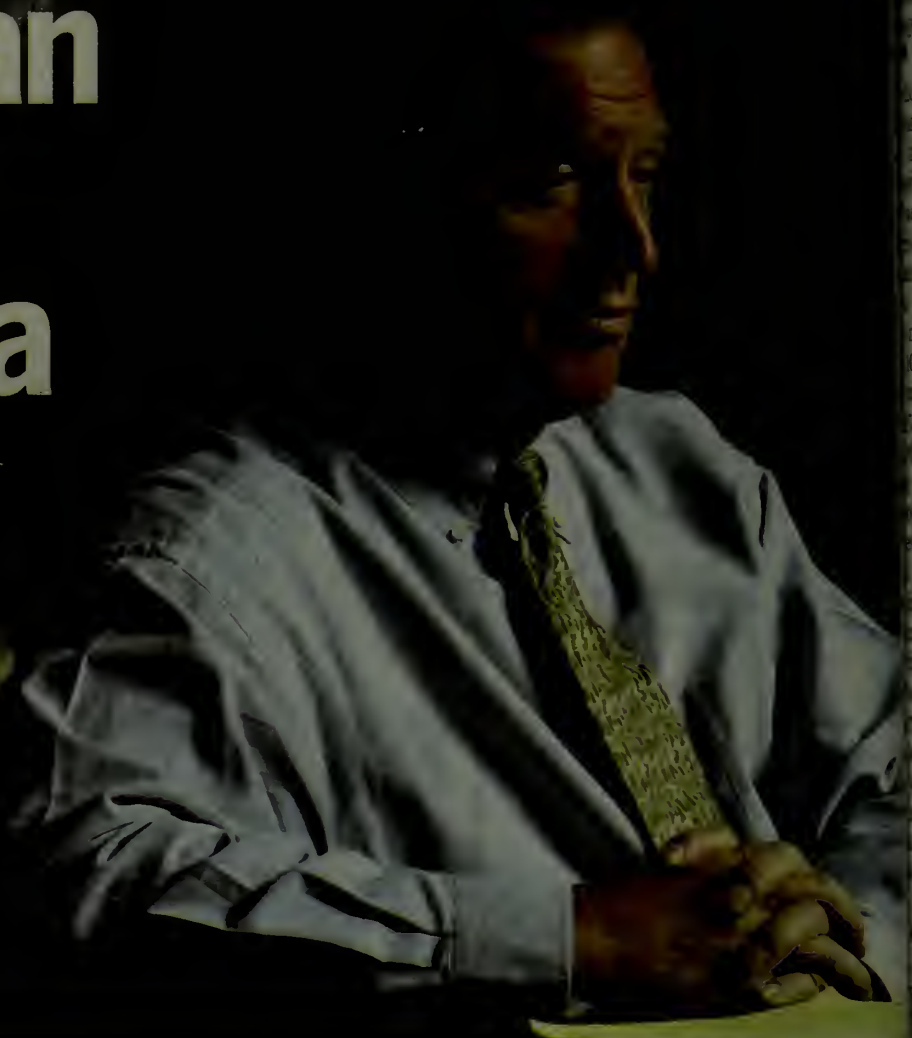
By Peter Burrows in San Jose, Calif.

BusinessWeek online For a Q&A with Cisco's M&A chief, Dan Scheinman, go to businessweek.com/extras

BusinessWeek online Read the case for and against the stadium at www.businessweek.com/extras

American Funds' Dilemma

Will too much growth make it a victim of its own success?



THEY'RE THE BIGGEST money managers you've never heard of. American Funds Group, owned by Capital Group Cos., doesn't advertise its mutual funds in any mainstream media. Managers and company higher-ups, such as Executive Committee Chairman Paul G. Haaga Jr., routinely turn down press interviews. Although the firm is the largest tenant in its downtown Los Angeles skyscraper, you won't find a single sign of its presence.

All this is because American doesn't want its own brand name to upstage those of brokerage firms such as Edward Jones, A.G. Edwards, and Merrill Lynch, through which it sells its funds. The strategy is paying off. For the second year in a row, American has been the top recipient of new money in the mutual-fund industry, raking in nearly \$84 billion last year, more than a third of all new fund investments, according to Boston-based Financial Research Corp. Three of its funds—

the \$95 billion Growth Fund of America, now the country's largest actively managed fund, and Washington Mutual and the Investment Company of America, each with \$76 billion—are bigger than Fidelity Investments' Magellan Fund, the former champ. If the trend keeps up, American will overtake Fidelity Management & Research and Vanguard Group as the nation's top fund manager.

STEEP FEES

ALL THREE FUND giants have benefited from big inflows in the wake of scandals at other fund families. But the avalanche of new money potentially poses more problems for American than the others. Its assets under management have nearly doubled, to \$656 billion, over the past five years, a dizzying growth rate far faster than those of its rivals. American operates just 29 funds, vs. 360 at Fidelity and 110 at Vanguard, so its individual funds tend to swell much faster. Unlike many other fund families, American refuses to close its funds to new investors to limit

the amount of money it needs to de-

The risk is that American's funds get so big that they become little more than index funds and can no longer justify charging investors steep initial fees up to 5.75%—of which brokerages typically get five percentage points or more to buy a fund. A similar problem crimped Fidelity's Magellan Fund in the 1990s. Such worries could encourage defections. Says Michael J. Francis, president of Francis Investment Counsel LLC, a retirement plan consultancy in Hartland, Vt.: "I'm telling my clients to consider other funds." Besides, much of the money flooded into American came in the three years when the large-company fund outperformed the S&P 500. Should the market shift to favor companies with faster-growing earnings, performance could suffer.

Nor has American emerged from fund scandals completely unscathed. It was under investigation by the Securities and Exchange Commission and the California Attorney General's office for alleged

American avoids stars managers making undisclosed payments to brokerage firms that gave it preferential treatment. American

did nothing wrong. "We disclosed as considered an acceptable level time," says spokesman Chuck off. "The SEC saw our prospectus—never raised the issue."

American has been popular with bro- mainly because of the returns it has. Its stock and bond funds have most competitors over the past 1, 10 years, according to mutual-fund her Lipper Fund Analysis. Ameri- 5 stock funds returned an average 8% a year through the 10 years last Dec. 31, vs. 9.9% for compet- nds. While American's initial sales s are high, ongoing annual ex- average just 1.1% of assets, vs. or the industry, according to fund her Morningstar Inc. Also, Ameri- funds tend to have a low turnover in oldings of just 27% a year, less than ter of the industry's 106% average. eeps costs low—and reduces taxes restors.

American was founded by Jonathan B. ace, a stock ana- ho sold his stake Michigan money gement firm in because he ht the market was othy. Setting up n shop in Los An- two years later, he d it conservatively ecades. American avoided industry such as sector focusing on one try. "They tend to art anybody," says industry consult- Geoffrey H. Bo- "I don't believe ve ever had a fund up on them."

velace, who died 79, helped create ican's unique gement structure. funds are run ei- by individuals or a of managers. ican uses a com- ion. Within each , individuals man- specific amounts of ey. Their compen- n is tied both to

their performance and that of the fund. It's cal- culated on a rolling, four-year average, so no one has an incentive to take big risks to boost their annual bonus.

American's Freadhoff says this structure is key to dealing with big in- flows. Rather than clos- ing a fund, American simply adds managers. Five years ago, for exam- ple, the Growth Fund of America had four main managers. Today it has eight, so al- though its assets have tripled, the amount supervised by each manager has not risen as much.

RISKING SAMENESS

THIS WAY, American avoids the risk of a star manager going cold or a team paralyzed by consensus building. Still, the formula has its downside. By continuing to add managers to a fund, it risks diluting the performance of the other managers. "You do have to worry about the asset growth," says Don Phillips, managing director at Morningstar. "Their strategy assumes they can bring in new people who are just as talented. Think about expansion teams in baseball. If you bring in 10 more teams, it waters down the talent."

Most of American's managers preside over pieces of two or three funds and rely on the same pool of in-house analysts, who also manage parts of each fund. The results: Many of the funds have similar stocks in their portfolios. For example, the firm's two equity-income funds, Capital Income Builder Fund and the Income Fund of America, have 59 of their top 100 stocks in common. Says T. Clifton Green, an asso- ciate professor of fi- nance at Emory Univer- sity: "If you spread your money across these funds thinking you're getting diversifi- cation, you're not."

Freadhoff argues

THE STAT

\$84 Billion

Net inflows into American Funds last year, up 30% from '03

Data: Company

that since American sells its funds only through brokers, clients are getting advice that encourages them, for example, to diversify their portfolios between growth and income funds. "Often [American] funds are designed to do similar things, but there are subtle differences," says Drew Taylor, a vice-presi- dent at Capital Research

& Management Co., the Capital Group unit that manages the American Funds. "One may have a little more money in bonds. Another may have more overseas. You don't want to own both."

American uses that same matter-of- fact logic in its handling of the probes it is facing. Investigators are focusing on two kinds of payments made to brokers. In one, a practice called directed brokerage, the mutual-fund companies funneled stock trading orders—and fat commis- sions—to brokerages that sell its funds. Federal and state investigators are also looking into revenue sharing. That's when fund managers rebate a portion of their fees to brokerages, based on how much client money that they put and keep in the fund family. The practice isn't illegal if it's disclosed. But it can encourage brokers to put their clients into funds that rebate the most rather than the ones best suited to their needs.

American discontinued directed brokerage in late 2003, shortly before the SEC banned it, says Freadhoff. He acknowledges that the company still makes payments to firms that keep large amounts of client money in its funds but says the payments are small—averaging no more than \$20 for every \$10,000 invested—and disclosed in the fund prospectus. Last year, Franklin Templeton and some Pimco stock funds settled suits over these issues with the SEC and the California AG for \$38 million and \$20 million, respectively. American has not.

By stubbornly sticking to its convictions, the firm has done well over the years. Even now, the investigations haven't slowed the money flowing into American. "They take care of the brokers, and brokers are taking care of them," says Steve Blankenship, a principal at Heritage Financial Planning in Grapevine, Tex. Now, American has also to take care of the money that's pouring into its funds. ■

—By Christopher Palmeri in Los Angeles and Adrienne Carter in Chicago, with Amy Borrus in Washington

A Flood Of Money

American has been the top recipient of new cash, despite nagging questions about the firm

GROWTH

American hasn't closed any of its 29 funds even though some saw assets jump by 50% last year. The biggest, the Growth Fund of America, manages \$95 billion.

INVESTIGATIONS

Federal and state regulators are looking at the firm for allegedly making undisclosed payments to brokers who sell its funds. Unlike other fund families, the company hasn't settled, saying it has done nothing wrong.

INVESTMENT STYLE

Its conservative, value-oriented stocks are hot right now, but their performance could wane if growth stocks come back into vogue.

Data: BusinessWeek



A Hedge Fund That Can Boogie

After a series of music-industry deals, JDS Capital is getting buzz

LUNCHING ON PASTRAMI sandwiches and pickles in their midtown Manhattan office, Joseph D. Samberg and Daniel C. Stein could be tin pan alley music producers. They strategize with an employee on how to market songs after Stein spent much of the morning discussing how to develop artists shed by major labels. But Samberg and Stein aren't just music men. They run a private investment firm, JDS Capital Management Inc., that is quickly building a digital-music empire.

After a series of deals, Samberg, 34, and Stein, 35, have emerged as pioneers in online music—the fastest-growing part of the business. In November their fund put up an estimated \$50 million to buy the music-publishing arm of DreamWorks, giving it all rights to such evergreens as John Denver's *Rocky Mountain High* and Bob Marley's *Get Up, Stand Up*. Before that the fund bought eMusic.com Inc., an online music retailer, from Vivendi Universal for about \$15 million. Now

the two are eyeing other digital-music companies and talking about branching into digital videos.

Suddenly, Samberg and Stein are getting plenty of buzz. For one, their songs have no built-in copyright protection, since downloads are in the MP3 format. So eMusic's tunes will play on Apple Computer Inc.'s iPod, unlike those for almost all for-pay music services such as Napster. Their businesses are formidable niche players in selling digital music, a \$500 million market expected to quadruple by 2008. It's lucrative because the fixed costs of selling music online are low. And there's always the chance that one of their unknowns will make it big. "They're a meaningful player," says Phil Leigh, a senior analyst at market researcher Inside Digital Media Inc.

SAMBERG AND STEIN Going digital

With a portfolio of music companies, JDS Capital is not a typical hedge fund. Indeed, it's part of a trend of funds buying companies instead of just trading them. Samberg and Stein lock up their investors in a private equity part of their firm for years, keep their financials secret, and stick with investments for as long as five to 10 years. And, says Stein: "We always have controlling interests."

MY BOYFRIEND'S BACK

THE DUO DIDN'T SET OUT to be entertainment moguls. The two brothers were roommates at Cornell University before going their separate ways. In 1996, Samberg, a former portfolio manager at mutual-fund company Berman LLC, started a hedge fund. Then he spotted big opportunities in music companies that were reeling because of rampant piracy.

He recruited Stein to run business. His fund snapped them up. Stein started playing piano at age 3 and performed in bands in college. He later founded and sold a company that provided cabaret programs for college students, such as a late-night cooking show that demonstrated how to make baked Alaska with a blowtorch. Before joining JDS in 2003, Stein ran an Internet wedding registry that he later sold to Martha Stewart Living Omnimedia Inc.

At JDS, Stein manages the firm's digital-music investments. Samberg sticks to the business side. They sit at the opposite ends of a 17th-floor Park Avenue office adorned with records. Stein is surrounded by music veterans such as Richard Gottehrer, producer for the 1960s girl group the Go-Go's, who also wrote the hit *My Boyfriend's Back*.

The way JDS operates gives Samberg a trading edge. He says he spots potential investments—such as music group EMI—which he traded for a 50% profit—quicker than rivals. He says having a major company in the office gives him insight into valuations and industry trends.

It's too soon to tell if Samberg and Stein's strategy will go platinum. But far they're rocking and rolling. ■

—By Emily Thornton in New York, and Peter Burrows in San Francisco

Fast Groove

JDS Capital is creating a digital-music empire

DATE	BUSINESS PURCHASED	PRICE*
Nov. 2004	DreamWorks' music-publishing unit	\$50 million
Oct. 2003	eMusic, an online music retailer	\$15 million
Mar. 2003	The Orchard, a digital distributor of music	NA

*Estimates. NA=Not available

Data: BusinessWeek

MEY STONE

How Banks Pretty up the Profit Picture

Tinkering with loan-loss reserves can produce deceiving earnings

LAST YEAR THE BANKS had an easy way to juice their profits. All they had to do was allocate a little less money to loan-loss reserves—the money they set aside to cover bad debt. As the economy has improved and defaults have slowed, many decided they didn't need as much in reserves as they did in 2003, and presto, their earnings per share would rise a few cents.

Investors who assume the banks are humming and decide to bank stocks could be in for a surprise. In 2005 many banks won't have this profit source. Some have already pared loan-loss reserves as much as they reasonably can, analysts say. "A lot of banks may do this from time to time to meet estimates," says Brian Shullaw, senior research analyst at SNL Financial in Charlottesville, Va.

The trouble with whittling away reserves is that as banks write off loans, they will have to replenish the reserves. Plus, if credit conditions worsen as economic growth slows and interest rates rise, they will have to set aside even more, eating into profits.

With a little digging, and the current numbers don't look so great. Citicorp's Comerica Inc. had one of the largest drops in its loan-loss reserves relative to total assets, according to a study of large banks' fourth-quarter earnings done by SNL Financial's *BusinessWeek*. Not only did Comerica add money in the fourth quarter, it also extracted \$21 million from its profit. That gave it an extra \$98 million in income, or 57¢ a share, that it didn't have last year. The bank analysts' earnings estimates by Comerica Chief Credit Officer

Dale Greene says muted loan growth, coupled with major improvement in credit quality, justify the move.

Others, such as Citigroup, garnered a few extra cents from replenishing reserves by a smaller amount than before. But it was enough to help them beat analysts' earnings estimates by a penny or two. Citi Chief Financial Officer Sallie L. Krawcheck said in a Jan. 20 conference call that the reserving process was done in mid-quarter based on a mathematical formula. She noted: "We as a company work very hard to systematize the process around rigorous analytics."

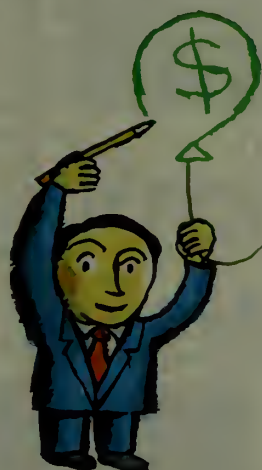
Of course, banks can't just shift funds around willy-nilly. Accounting rules dictate that they have to justify decreases in loan-loss allowances, for example by citing substantial improvement in credit trends. This past quarter, a bevy of bank earnings releases cited fewer nonperforming loans, improving asset quality, and a stronger underlying global economy as reasons for smaller loan-loss provisions. Bill Lewis, leader of the U.S. banking practice at PricewaterhouseCoopers, notes that subjectivity is often involved, but "most banks, in light of heightened regulatory scrutiny, are more precise in their estimation methodologies today than they have been in the past."

Maybe so, but even if the decreases in reserves are perfectly justifiable, there are still problems with this common industry practice. Besides cutting reserves to the core, banks "are increasing the cyclicality of earnings," says Richard Bove, a banking analyst at Punk, Ziegel & Co. "When bad times come, you know they are going to be increasing the size of the reserves." Already, Citi's Krawcheck has warned analysts not to expect substantial reductions in provisions in the future.

Tinkering with loan-loss reserves also distorts the true quality of bank earnings. A dollar of earnings in a quarter when the provisions are being reduced isn't as valuable as one when

they're the same or rising. "Everybody can play the loan-loss game to varying degrees, and the market is generally going to see through it," says Craig Woker, a bank analyst at Morningstar Inc.

But that's not so easy for those investors who aren't well-versed in the nitty-gritty of bank bookkeeping. Bove thinks that bank reserve accounting needs a major overhaul. "In reality, it is really nothing more than a bunch of accountants flipping coins and playing games," he says. For now, investors should realize that the gravy train of 2004 may soon grind to a halt. ■



RAIDING THE PIGGY BANK

Some banks are reducing reserves for bad loans, helping them to beat earnings estimates

	FALL IN LOAN-LOSS PROVISIONS* (MILLIONS)	CONTRIBUTION TO EARNINGS PER SHARE	BEAT CONSENSUS ESTIMATE BY:
Citigroup	\$807.0	15¢	1¢
Fifth Third	28.6	5	2
Associated	6.0	5	1
Compass	4.1	3	2
First Horizon	3.6	3	1

*Fourth quarter, year-on-year

Data: SNL Financial

COMMENTARY

BY ADRIENNE CARTER

Will This Merger Go Down Smoothly

Molson and Coors are both family-run—and may be headed for a showdown

WITH THE FEB. 1 vote by Adolph Coors Co. shareholders to approve the merger with Molson Inc., the extended courtship between the two companies came to an end. But the hard work of making the merger succeed is just beginning. The company's new heft is supposed to give it more muscle to deal with the shrinking market share in its two home markets and a more competitive global beer industry. Rapid consolidation, combined with the growing threat of wine and spirits, has made it difficult for smaller players to make it on their own. Nevertheless, the terms of the deal may saddle the new company with major management problems. The two family-dominated partners structured it as a merger of equals. In the executive suite and the boardroom, that means neither side is clearly in charge. Such co-leadership structures seldom work. And family control of both companies—with all the history, pride, and expectations this implies—creates additional complications.

On paper, the deal looks like a smart move. Molson Coors Brewing Co. will be the world's fifth-largest brewer, with \$6 billion in sales. While that's not enough clout to go head-on with goliaths Anheuser-Busch Cos. and InBev, it does reduce the risk. Coors Light accounted for half of Adolph Coors's earnings; for Molson Coors, that brand's bottom-line impact is about 20%. "The merger doesn't fix the company's core problems," says Marc I. Cohen, an analyst at Goldman, Sachs & Co. "But it makes each of the problems they face less significant."

A Volatile Mixture

EXCEPT FOR ONE. Mergers of large, publicly held, family-dominated companies have been rare, and with good reason. Powerful personalities, intra-family rivalries, and the inevitable battle for control make such unions difficult—in the words of management guru Tom Peters, "virtually unthinkable." For Molson Coors, avoiding those problems may be the most critical challenge of all. If the two families clash, the resulting management mayhem will make taking on their bigger, better-positioned rivals all but impossible. And conflict may be inevitable. Even the company concedes that meshing the two

companies will be difficult. "Each culture has relative strengths and weaknesses, and we need to pull the positives from each," says Coors CEO W. Leo Kiely III, who will be CEO of the combined company. "It's going to be hard and challenging work."

By structuring the deal as a "merger of equals," the two may have created a power vacuum that leaves both far from jockeying for dominance. M&A history books include few deals where both companies triumph; one side always comes out on top. DaimlerChrysler claimed the union of the two makers was a merger of equals. That fiction was quickly scrapped amid management turmoil caused by colliding American and German corporate cultures and financial failures at Chrysler. A similar outcome could await Molson and Coors. "Family companies operate like monarchies," says Kenneth Preston, professor of management and entrepreneurship at New York University's Leonard N. Stern School of Business. "It's really difficult to have a merger because somebody has to be in charge, and that can be a problem."

The board structure won't make corporate life any easier. Molson shareholders end up with a slight edge in shares—55% vs. 45% for the Coors owners. But that won't necessarily give them full control. Coors's Kiely becomes CEO, while Molson's CEO, Daniel J. O'Neill, moves into the executive position of vice-chairman. Most important, the board will be split equally between the two families.

The deal puts neither side clearly in charge



addition to Kiely and O'Neill, it include five members elected by the family, five by the Coors family, three outside directors elected by shareholders.

Already named to the new board: Chairman Eric H. Molson as an, and Andrew, his son—plus Chairman Peter H. Coors and his daughter. Kiely has been d with reviving Coors, in part by g the focus from products to mar- a process that Pete Coors, great- on of the founder, has shepherd- eill, a former H.J. Heinz exec, has Molson on cutting costs and g core brands, while the Molson has kept a low profile.

With power so evenly divided, it's rd to imagine inter- and intra- battles. Merger partners, such as hat formed Time-Warner Inc. in ave had much the same experi- even without the complicating of family. The family members at n Coors could make for a volatile Industry observers say Peter who recently lost his Senate may want to exert his influence; Ian Molson, a large shareholder stant cousin of Eric Molson, has harsh critic of the merger. Susan ltz, CEO of Board Institute Inc., a rate governance services firm, he even split between the two es could create gridlock. Says : "If there is an impasse at the , [one family] can block the venture."

Despite the inherent problems of ng two family-controlled compa- the Molson Coors deal has a few s in its favor. For one, Coors man- ent has successfully integrated ac- ions with similarly strong cul- In 2002, the Rocky Mountain er acquired a portfolio of brands ncluded Carling, the No.1 lager y sales in Britain, which still re- d a strong family-company cul- The integration wasn't seamless. t worked, in part because Coors aced some of Carling's innova- such as its sales tactics in bars.

Furthermore, Coors and Molson e some history. Molson brews s for the Canadian market, and s sells Molson in the U.S. And both anies have been run by nonfami- anagers for at least a decade, h should help with integration. it won't be an easy mix. Family oil is one ingredient sure to make merger go flat. ■

LACHLAN MURDOCH Can he succeed where his father didn't?



Profitless Paper in Relentless Pursuit

The *New York Post* may be in the red, but it's determined to beat the *Daily News*

ONCE UPON A TIME, the newspaper war was as common a ritual of civic combat as the mayoral election or the cross-town high school football game.

The inexorable decline of newspaper reading has left even most big U.S. cities with a single daily. The glaring exception is New York City, home to four of the 15 largest papers. The huge circulation gain

logged of late by the oldest of them—the *New York Post*—has escalated its archrivalry with the *Daily News* into the sort of apocalyptic struggle not seen since William Randolph Hearst and Joseph Pulitzer locked egos a century ago.

This latter-day war also features two high-profile personalities: Rupert Murdoch, chief executive of News Corp., owner of the *Post*, and real estate developer Mortimer B. Zuckerman, owner of the *Daily News*. This is a mismatch. Zucker-

The battle is really Murdoch vs. Zuckerman

How the **Post** Grew and Grew

AGAIN BUY Cutting the cover price to 25¢, from 50¢, in 2000 immediately boosted circulation by 40,000 and continues to encourage sampling.

EXTREME MAKEOVER A \$250 million printing plant brought a sharper look and increased the use of four-color illustration.



HOT COPY A new editor-in-chief doubled the story count and reemphasized such classic tabloid fare as sex and celebrity. On the day the *Post* ran its Berra exclusive, the *Daily News* lead with the Pope.

PATRIOTIC PUSH After September 11, both the *Post* and the *Daily News* added American flags to their nameplates. Only the *Post* still carries the flag, as befits its staunchly pro-war, pro-Bush agenda.

HARD SELL The *Post* has made extensive use of "part-works"—glossy magazine inserts—and other costly but effective promotional techniques imported from Britain and Australia.

man is a billionaire, but his pockets are not nearly as deep as Murdoch's, and neither is his media expertise. With \$22 billion in revenues, News Corp. is so big that the *Post*'s budget amounts to a rounding error. Even so, the tabloid looms large in Murdoch's calculations as News Corp.'s print megaphone in the media industry's capital city and as a proving ground for his son and heir apparent, Lachlan K. Murdoch, the *Post*'s 33-year-old publisher.

PROVING GROUND

THE *DAILY NEWS* remains much the stronger paper financially, earning in excess of \$15 million on revenues of about \$340 million in each of the past two years, according to an authoritative source. The *Post* has lost so much money for so long that it would have folded years ago if News Corp. applied the same profit-making rigor to the tabloid as it does to its other businesses. Could the *Post* turn a profit if the *Daily News* vanished? *Daily News* executives and many neutral observers believe the Murdochs are determined to find out. Says Martin Dunn, who long worked for News Corp. before joining the *Daily News* in 2003 as editorial director and deputy publisher: "I've been on the other side. I know that when News Corp. sets out to destroy someone, they go all out to do it."

As deputy operating officer—News Corp.'s third-highest position—Lachlan Murdoch oversees a far-flung mix of businesses, including dozens of newspapers in Australia and Fox TV's 35 stations in the U.S. Yet he devotes one-third of his time to the *Post*, compelled both by affec-

tion for the feisty tabloid and its home city and by dynastic ambition. What better way for the son to prove he's deserving of the crown than to do something that the father never could: turn the *Post* into a money-maker? (News Corp. bought the paper in 1976, sold it in 1988, and reacquired it in 1993.)

Lachlan Murdoch refuses to disclose the *Post*'s annual loss—pegged by outsiders at \$15 million to \$30 million—but acknowledges that it widened when the weekday cover price was halved, to 25¢, in 2000. It's all part of the plan, says Murdoch, who intends to restore the 50¢ cover price if and when the *Post* passes the *Daily News* in circulation. "We love the *Post*, but it's not a hobby," he says. "We very much care that it make money one day, and that it become as great a business as it is a newspaper."

Lachlan struggled in some of his earlier News Corp. postings, but at the *Post* he has engineered a rise in readership of a magnitude that few thought possible in the Internet Age. In the five years ended on Sept. 30, the *Post* boosted its average weekday sale by 49%, to 686,207 papers. Meanwhile, the *Daily News* saw its circulation fall slightly, to 715,052. Leave off bulk sales to schools, retailers, and the like, and the *News*'s lead of some 29,000 papers shrinks to 6,000.

However, on Sunday—payday for most papers—the *News* retains a commanding lead of 786,952 to the *Post*'s 452,871. What is more, the *Post* has not been nearly as successful in attracting advertisers as readers. The 753,116 column inches of

display advertising the *Post* ran in amounts to just 45% of the lineage *Daily News* and 18% of *Newsday*, the metro area's third major tabloid, according to TMS Median Intelligence CM.

How did the *Post*, founded in 1784 by Alexander Hamilton, become America's fastest-growing weekday newspaper in the 21st century? The 25¢ price has to do with it, but no more than did the \$250 million printing plant that enhanced the paper's look and kept it on the page—instead of readers' minds. In 2001, Murdoch installed a new editor, Col Allen, a famously brash News veteran steeped in the cutthroat New York newspaper market. "I took the view that the paper was ponderous and needed to be made edgier," says Allen, who cut story lengths, doubled story counts, deleted more space to photos (especially ones), and upped the *Post*'s daily quota of sex, celebrity, and scandal.

VULNERABLE TO FREEBIES

"THE *POST* HAS done everything I would prescribe that a newspaper of its size should do to build circulation," says Robert B. Water, a managing director of Ventures, a New York merchant bank specializing in the media business. "Above all, it has a distinctive personality. It's not one of those squishy, one-size-fits-all suburban papers."

However, Broadwater and other risk takers doubt that the *Post* can ever be as securely profitable as long it coexists with the *News*. Only 26% of *Post* readers buy the *News* exclusively; for the *News* the figure is 60%. In effect, Murdoch has succeeded only in making the *Post* New York's favorite extra read. This leaves the paper particularly vulnerable to the two dailies launched over the past 18 months—*amNew York* and *Metro*. Most important, it is the *Post*'s also-read status that puts off advertisers above all else.

The question ultimately is whether the *Post* can drive the *News* into the red. It could induce Zuckerman either to fold the paper or sell it to News Corp. Zuckerman may not be a megamedia mogul, but he didn't get to be a big-time developer by being a pushover. Zuckerman, 67: "If I had any business I'd like to let my daughter become involved in, it's the *Daily News*." Abigail Zuckerman is 7. This is one fight to finish that appears to be a long way from over. ■

—By Anthony Bianco
New York

The *Post* is now New York's favorite extra read

COMMENTARY

ROGER O. CROCKETT

How the NAACP Could Get Its Clout Back

Needs leadership, new members, money, and creative programs

AFRICAN AMERICANS have lost a lot of ground in recent years. True, their economic prospects brightened during the 1990s boom, as did those of so many Americans. But the subsequent slowdown hit them harder than any other group, and without fast action, the effect could be deep and lasting. Blacks are still twice as likely as whites to be unemployed, and three times as likely to be poor. Their incomes and wages still lag the national average, and they graduate from college at half the rate of whites. Meanwhile, blacks' historical status as the country's largest minority has been overtaken by Hispanics, whose rapidly growing ranks seem to give them problems more urgent than those of blacks. Since 1909, the National Association for the Advancement of Colored People has been black America's main source of civil rights leadership. Its victories are legendary, from the landmark Supreme Court school desegregation case, *Brown v. the Board of Education*, to the 1965 Voting Rights Act. Even today, it is the only national group working for racial fairness in every state. Unfortunately, this venerable organization has begun to lose its way. Kweisi Mfume, the president for the past nine years, retired in January after fixing the NAACP's mid-1990s deficit. He largely failed to breathe new life into a

group whose boycotts, marches, and fund-raising banquets often seem stuck in the 1960s. At a time when the Baltimore-based advocacy outfit should be a fount of new ideas, it's contributing little in the way of fresh thinking in the continuing battle for civil rights and economic programs.

Mfume's departure presents the perfect opportunity for the NAACP to reinvent itself. As the group kicks off its annual meeting on Feb. 19 in New York, it should look hard for a leader with the stature and savvy to try new approaches. Perhaps its biggest need is for new and motivated membership, not just to expand its stagnant numbers and inadequate budget but also to reach out to black youth, who largely ignore it. And as doors have opened for some blacks, distance has come between the black middle class and the black poor, between black conservatives and traditional liberals. Long a voice of the dis-

1963 PROTEST

Today's black youth largely ignore the organization



enfranchised, today's NAACP faces the challenge of representing a more diverse black America. The NAACP must reach across the aisle and find people with all persuasions," says Charles J. Ogletree Jr., a professor at Harvard Law School.

Consider that the group's membership of 500,000 is no larger today than in the 1940s, when the modern civil rights movement was just getting underway. Yet the black population has more than doubled since then, to more than 30 million. Mfume, to his credit, has worked hard to eliminate the red ink the organization produced. But while he stabilized the finances in recent years, the NAACP's \$27 million annual spending still falls far short of what's needed to give a major voice to black Americans.

The key to growth is youth. Only 10% of NAACP members are under 25, and most are well over 40. In fact, many members don't even know what the organization stands for, says J. Wyatt Mondesire, president of the Philadelphia chapter. The group's ties to cultural leaders used to be stronger: Fifty years ago, black baseball stars like Jackie Robinson and entertainers such as Aretha Franklin and Louis Armstrong frequently appeared at NAACP events to help boost the cause. Yet today there are plenty of high-profile sports and entertainment figures who could help mobilize young people if the organization made an effort to reach out to them. Hip-hop moguls Sean "P. Diddy" Combs and Russell Simmons pushed to get young blacks out to vote in the 2004

The NAACP "needs to...make activism hip"

tions. But Mondesire says the group has to become more respectful of youth. The NAACP "needs to speak their language and make activism hip," he says.

With more energy, the group could tackle more creative issues effectively. Take education.

Just 17% of 25-to-29-year-old blacks completed a bachelor's degree, compared with 34% of non-Hispanic whites in this age group. Equally discouraging is the high school dropout rate for blacks, which hasn't changed in a decade: Only 88% of these 25-to-29-year-olds had graduated, vs. 94% of whites. One way to help would be to mount "education matters" seminars at churches and cultural clubs, or hip-hop concerts.

Alternatively, the group could roll

People like Joan are the reason for an investment firm like ours.

RAYMOND JAMES

Joan, 72, a 34-year-old attorney, San Jordan attends private college in Chicago. Joan hopes to retire and open a coffee house. She'd like to call it "Joan's Place."

...ves and get more involved in the school movement. Across the country, some charter schools offer better opportunities for kids in inner cities, suggests Steven Rogers, a professor at Western University's Kellogg School of Management. He points to the good Marshall Academies in Washington and Harlem—small public schools with 200 to 500 high-achieving students, almost all of whom go on to college. Venture-capital funds are flowing to many such schools in cities like Chicago, which just approved several new charters. What if

numbers. The National Urban League, another civil rights group, specializes in job and business skills training. Given the importance of this topic, the NAACP could work more closely with the League to fund training for black entrepreneurs.

A little innovative thinking might even help to boost home ownership, the chief source of wealth in America. Just 48% of blacks owned a house in 2003, unchanged from 2000 and well below a white rate of more than 75% that continued to climb after the 1990s boom ended. Several factors explain the big difference, including blacks' poor credit scores and below-average incomes. But discrimination remains an issue as well. The NAACP has long pushed for tougher federal poli-

More Advancement Needed

...nied by stagnating membership and membership turnover, NAACP has been unable to come up with an agenda to get blacks' slowing economic and social progress:

FLAT MEMBERSHIP At about 500,000, it's no larger than in the 1940s

NO YOUTH APPEAL Just 14% of members are under 25 and most are over 40

LEADERSHIP TURMOIL The NAACP is trying to replace Kweisi Mfume, who stepped down as president in January—a process that could take months

BUDGET CRUNCH In recent years, the group has turned a \$3.2 million debt into a surplus, but its \$27 million annual budget is still paltry compared with those of some other national advocacy groups

...NAACP adopted a school or two and lent its good name? In exchange, it ask for guarantees that such schools don't crowd out students from the community as they become successful. A central complaint about them. If efforts worked in one city, the NAACP "could take the model national," Rogers says.

...it might try a similar approach with success. Of course the NAACP can't remedy the problem alone. But its local branches could do plenty to offer support to the black unemployed if they focus on black business growth. In a recent survey by the Atlanta-based Boston Research Group, nearly 50% of black entrepreneurs said that employment in their companies was higher than six months ago. Many of those employees are African American. Business executives note that substantially more job creation comes from growth in black-owned businesses that hire blacks at a stronger rate than mainstream businesses.

...blacks also could benefit from more training in entrepreneurship, where Hispanics far outstrip them in terms of sheer

...cies, such as a 1988 law that gave the Housing & Urban Development Dept. more power to enforce housing anti-discrimination laws. But HUD has done little to step up enforcement, says John M. Yinger, a Syracuse University professor of economics and public administration.

The NAACP could take this issue on by compiling the sort of report cards it now produces on corporations and elected officials. Publicly grading agencies such as HUD might spark more action. And working with other advocacy groups more closely could instill more accountability into everyone from housing authorities to mortgage bankers. The NAACP should "push federal organizations to use its tools," Yinger says.

No one expects just one organization like the NAACP to solve all of black America's problems. But fresh leadership and creative thinking could go a long way toward invigorating black achievement, improving the nation along the way. ■

BusinessWeek online For an interview with NAACP Chairman Julian Bond, go to www.businessweek.com/extras

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Mobile payments key to rise in m-commerce

It has long been hoped in the mobile industry that the mobile phone will evolve from simply being a communication device. Yet, mobile commerce and using the mobile device to make transactions is not a "no brainer" for users – it needs to be made attractive. For users to want to make mobile transactions, mobile payment systems must be simple, reliable, secure and ubiquitous. Early mobile transactions required up to 60 key presses. This ideally needs to be fewer than five.

Security is absolutely key, both in terms of reality and perception. While there has been much focus on Internet fraud, some security experts fear that the mobile phone is much more open to abuse. Before users start making payments or sending their credit card details across the mobile Internet, they need to have faith that the appropriate security is in place.

Linked to this is the issue of standards. People like credit cards because they can be used nearly anywhere. If mobile payments are to take off, then the same needs to be true. By developing strong standards and getting widespread industry support, security concerns can more easily be addressed.

The mobile industry has tended to struggle with developing any sort of standards around mobile payments. This is partly due to the complexity and variety of possible approaches. It is also due to competition and the differing needs of the stakeholders,

including mobile operators, handset makers, banks and credit card companies.

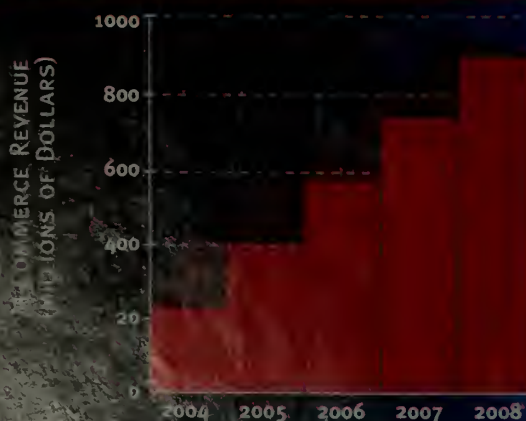
In Europe, this problem may be resolved by the launch of Simpay. This is a joint venture of four major operators: T-Mobile, Vodafone, Telefónica Móviles and Orange – with other operators likely to join the initiative. The scheme will allow payments across multiple carrier networks, allowing users to pay for goods or services from a wide variety of retailers and merchants. The payments made through Simpay will appear on the mobile phone bill of users.

European operators will also use their own mobile payment schemes in parallel with Simpay. One example is MobilePay from T-Mobile. This allows users to pay for goods and services using their mobile devices using credit or debit cards. By not processing payments through the mobile phone bill, T-Mobile will avoid the complexity and risk involved in doing this itself. This latter approach will lead to major opportunities for billing vendors, such as Amdocs, and mobile payment specialists, such as Euronet Technologies, to sell to the mobile operators. Turkey was one of the first countries in the region to introduce m-payments, with Turkcell working with Yapi Kredi Bank back in June 2004.

Of course, there are a number of other areas needed for success in m-commerce – from user friendliness to multi-carrier support – but getting the payments right is key to meeting realistic analyst expectations for market growth.

In Japan, NTT DoCoMo has taken a different approach. It launched its i-mode FeliCa service in July 2004, and by December had sold one million compatible handsets. The service is a combination of DoCoMo's i-mode mobile Internet service and Sony's FeliCa contactless IC chip technology. By simply waving a handset across a reader/writer, i-mode FeliCa allows the user to pay for goods and services using the handset as a credit card or cash. The handset can even be used as a house key or e-ticket. The widespread support for the service shows that this can be a successful model for mobile payments.

M-Commerce Revenue Projections for Western Europe



Source: The Yankee Group

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YOUR EXISTING
CUSTOMERS**

**AND THIS
IS A NEW
APPLICATION
THEY DIDN'T
KNOW THEY
NEEDED**

**THEN
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To avoid over-hyping subscriber expectations, many European operators have chosen a 'soft' launch for 3G.



What will be the real impact of 3G?

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The third generation (3G) of mobile networks is now upon us in most developed markets around the world. It is the evolution of existing mobile networks, CDMA and GSM, which were known as 2G technologies. To complicate matters, interim technologies such as GPRS were known as 2.5G, and the mobile industry is already talking about the launch of 3.5G in 2007. There is not even just one '3G' but at least two variants – cdma2000 from the CDMA camp and WCDMA from the GSM world. There had been fears that the Chinese would develop a completely different standard, T-SCDMA, although this is now likely to be compatible with WCDMA.

After much fanfare and concerns over the business model, particularly where large license fees were paid, what will 3G mean in practice?

In more developed markets, such as Japan and Korea, early expectations were not met, although this has recently been changing with, for example, the number of NTT DoCoMo's 3G(WCDMA) subscribers is hitting 10 million mark.

In Europe and the US, the jury is still out on the demand and impact of 3G. Many of the teething problems faced in Japan and Korea, have also been a problem in Europe and the US. These include reliability problems, high pricing, cost and lack of availability of handsets, and lack of compelling applications particularly when compared with the GPRS network. US operators have cautiously introduced 3G, with Verizon and Sprint launching initially as a business service available in a limited area. Cingular will launch its 3G network in 2005, although recent acquisition AT&T Wireless already has a limited service, with plans for all major US cities by the end of 2006.

To avoid over-hyping subscriber expectations, many European operators have chosen a "soft" launch for 3G. This has meant targeting business users of laptops with 3G datacards, and upgrading high-spending consumers to 3G phones.

Price has also meant that it is difficult to market 3G as a mainstream technology. For example, the basic price of 3G handsets remains around the €500 mark. For an operator like Telefónica Móviles, 90% of their Spanish handset sales are below €200.

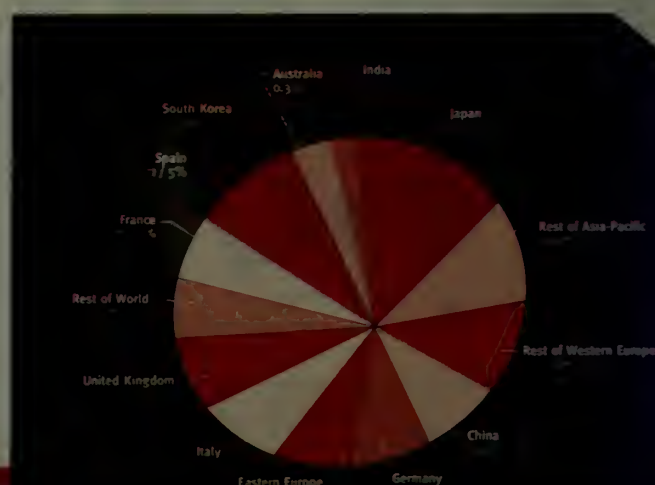
However, the desire for a slow introduction of 3G and to avoid massively subsidizing handset sales

has been tempered by factors that vary widely between countries. One issue is regulation, with some operators facing onerous license conditions that mean they must build out their networks quickly and therefore need to also offer services rapidly. A second issue is competition, with Hutchison operating in markets as diverse as the UK, Italy and Australia, a particular thorn in their side. Its success, with over 2.5 m subscribers in Italy, has been built on aggressive pricing of heavily subsidized handsets. It has also pushed voice calls on its devices, while other mobile operators would like to portray 3G as something offering a raft of new video and data services.

The market evolution for 3G will differ considerably between countries. In some, the regulatory and competitive pressure will force operators to push 3G hard, and we have already seen some of the aggressive promotions for Christmas 2004. In other countries, however, 2005 will still see 3G positioned mainly as a business solution and a complementary solution to other mobile technologies.

After 2005, the situation can change quickly. In some markets the pressure will come from network congestion problems as operators need the additional capacity supplied by 3G. In others, as the 3G network is built out and investor pressure builds, operators will want to quickly migrate users to the 3G network. In fact, as many users replace their handsets every 12-24 months, mobile customers will find themselves being naturally upgraded to 3G. By 2008, 3G users on the WCDMA standard will be widespread around the globe.

Top 10 WCDMA Markets by Users in 2008



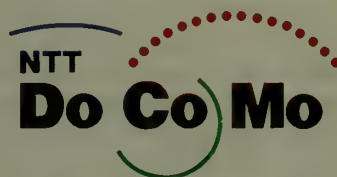
HE'LL NEVER KNOW A TIME WHEN
ER MOBILE PHONE WAS JUST A PHONE.

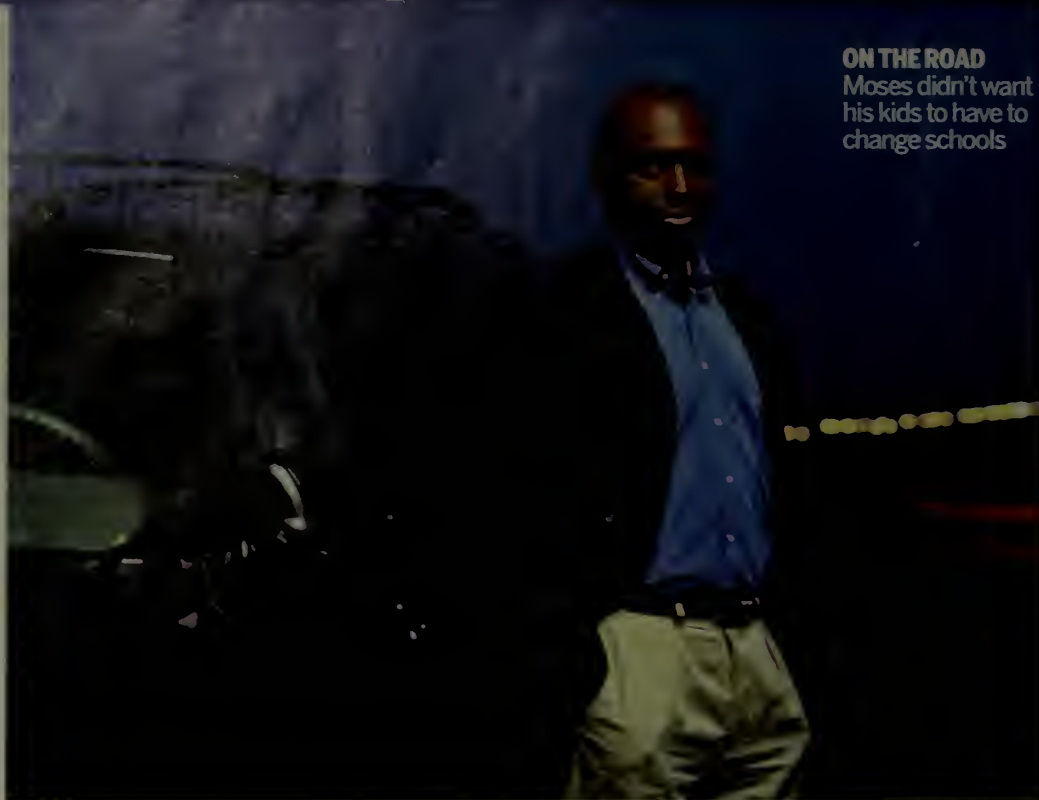


As Japan's leading mobile communications provider, NTT DoCoMo is taking the way we use our phones far beyond voice and the web — and into the world around us. With the power of contactless IC chip technology, travelers can stay on the move and consumers

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ON THE ROAD
Moses didn't want his kids to have to change schools

Extreme Commuting

More workers are willing to travel three hours a day. But what is the long-term cost?

FOR THE LAST LEG OF their five- and sometimes six-hour, door-to-door commutes, the working moms who call themselves the "Bus Buddies" of the Adirondack Trailways' Red Line run usually talk about one thing: How can I get off this thing? How to end the exhausting odyssey from New York state towns such as New Paltz and Woodstock, waking up at 5, 4, and even 3 a.m. to board a smelly long-hauler to Manhattan, where the salaries are 70% more? On the trip home, the Bus Buddies bring out their neck rolls to avoid "commuter nod" and use their pashminas as blankets, brainstorming exit strategies over the dueling aromas of Chinese food and Kentucky Fried Chicken. When a Bus Buddy does manage to leave behind her seat—such as Jennifer Pickurel, who traded in a big finance job for one at

the local Chamber of Commerce—the Bus Buddies erupt into applause. "We're jealous," says Terry Rust, a broadcast TV business manager who lives in New Paltz. "But we cheer them on and say: 'Yeah, you made it. You're off the bus.'"

HOUSING HUNT

THE BUS BUDDIES are part of the fastest-growing group of work travelers in the country, people who rarely see their houses in daylight, leave home when their kids are still asleep, and mainline Red Bull just to stay awake. They're known as extreme commuters. They spend at least a month of their lives each year traveling a minimum of an hour-and-a-half to work and back vs. the U.S. average of 50 minutes. Their

ranks have jumped an astounding 95% since 1990, according to Census Bureau, accounting for 1 million workers.

Experts say the numbers of supercommuters will continue to swell. In 1990, 24% of all workers left their home counties to go to work. Since then, 50% of workers do, according to transportation expert and *Commute America* author Alan Pisarski. Commute America is already on hand to note, with many companies attempting to ease the strain on employees (table). For many, the megacommuter is about the broadening search for affordable housing, with more and more people "driving until they qualify for cheaper houses and better schools," says Pisarski.

It's one reason the Blue Mountains have become a bedroom community of Washington, New Hampshire an exurb

Boston, and Modesto, Calif., an outgrowth of Silicon Valley. Cleveland Deland commutes three states to get to work every day. It takes the 4:30 a.m. bus from Stroudsburg, Pa., to his job as a union construction worker in Manhattan. Stephen Hendorff's daily trek alternately involves a combo of a car, a train, a bus, a ferry, and a subway from his home in Rock County, N.Y., to his job as a Bank of New York Co. bond salesman on Wall Street. "It's the biggest regret of my life," says Hendorff, 62, who says he was seduced by the prospect of a decent house.

This is what economists call "the commuting paradox." Most people travel long distances with the idea that they'll accept the burden for something better, be it a house, salary, or school. They presume the trade-off is worth the agony. But studies show that commuters are on average much less satisfied with their lives than noncommuters. A commuter who travels one hour, one way, would have to earn 40% more than his current salary to be as fully satisfied with his life as a noncommuter, say economists.

Bruno S. Frey and Alois Stutzer of the University of Zurich's Institute for Empirical Research in Economics. People usually overestimate the value of the things they'll obtain by commuting—more money, more material goods, more prestige—and underestimate

"I spend more time in my car than in my living room"

the benefit of what they are losing: connections, hobbies, and health. Commuting is a stress that doesn't pay, says Stutzer.

G KIDS IN THE PICTURE

THE GROWTH IN dual-income households is continuing to fuel the tally: 70% of households now have at least one worker. It might be possible to live near one person's job. But typically, people can't live near both. The flip side is also true: The 50% divorce rate of

ten leads to long-distance rides so parents can live near their kids even if they are unable to find jobs close by. Sometimes it's a question of keeping kids in their schools. Rick Moses, a single father of two girls, knows every divot and dead cell-phone zone on his three-hour journey from Bakersfield, Calif., to his job in Pleasanton managing national event sponsorships for sports marketing firm Ultimate Lineup. Moving closer is also out of the question, he says, because of Bay Area real estate prices.

Thanks to wireless and broadband, many affluent knowledge workers are converting commute time into work time. Jason Hanold crosses a time zone to get to his job as talent acquisition director at Whirlpool Corp. Waking at 3 a.m., Hanold drives 105 miles from his townhouse on Chicago's West Side to headquarters in Benton Harbor, Mich., so he can live near both his fiancée and his two boys, who live with his ex-wife. But he's able to conduct business during most of his morning ride and part of his evening ride on his cell phone. He started the job with a brand new Range Rover, racking up 62,000 miles in the first year. Now he drives an \$84,000 Mercedes sedan. "I knew it was a splurge," says Hanold, "but I spend more time in my car than in my living room."

Corporate job growth in the suburbs is pulling a slew of new low-income, rural workers into the commuting pack. The state with the biggest jump in commute times is West Virginia, where people are taking jobs as far away as Washington, Pittsburgh, and the metro areas of Ohio. These workers often live in second- and third-generation houses that haven't appreciated much, leaving them no choice but to travel for an average of four hours round trip for a living wage. The increasing availability of low-cost cars is also playing a role.

Still, the costs of commuting—in gas, congestion, pollution, sprawl—are high. Commuting is also associated with raised blood pressure, musculoskeletal disorders, increased hostility, lateness, absenteeism, and adverse effects on cognitive performance. Harvard University public policy professor Robert D. Putnam, author of *Bowling Alone: The Collapse and Revival of American Community*, says that for every 10 minutes of commuting time, one's social connections get cut by 10%. Imagine what that means when it's not a matter of minutes but hours. ■

—By Michelle Conlin in New York, with Lauren Gard and Rob Doyle in New York and Michael Arndt in Chicago



COMMUTER-FRIENDLY BOSSES

EPA recently ranked the best places to work for commuters. The top five:

INTEL Two-fifths of employees telecommute. Transit subsidy (\$30 a month). Ride-home buses for those who work late. Reserved parking for car poolers. Electric-car power stations.

FANNIE MAE Transit subsidy (\$100 a month). Half of workforce in some type of telework arrangement. Free shuttle service to offices.

CISCO SYSTEMS Free at-home broadband. Guaranteed ride home. Free shuttle between headquarters and public transit. Bike showers and showers in every building. Van pools and van pools.

USAA Van pools. On-site day care, gymnasium, restaurants, and credit union.

TIE: SUN MICROSYSTEMS Employees can work from home, drop-in centers, or campuses across the country. Prepaid transit passes. Free shuttle service around the Area.

ORACLE Free shuttles to public transportation. Discounted transit passes.

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That's Not Junk. That's Early Tech

Prices for early computers and other geek memorabilia are on the rise. **BY THANE PETERSON**

GORDON BELL CAN HARDLY BELIEVE what he sees when he scrolls through the online catalog for a Feb. 23 Christie's auction of computer memorabilia in New York. "Oh my God, the prices!" exclaims the Microsoft senior researcher, a big-time collector of computer-related books, documents, and other artifacts, most of which he has donated to the Computer History Museum in Mountain View, Calif. One thing that catches his eye in the 355-item "Origins of Cyberspace" catalog is a first edition of a 1617 treatise by John Napier, the Scottish mathematician whose invention of logarithms was a key advance in creating the early calculators that evolved into today's computers. The auction house figures it will go for \$25,000 to \$35,000. "I paid \$6,000 in 1982" for a similar copy, he recalls. Bell isn't the only connoisseur in a tizzy over the rising cachet and prices of computer memorabilia. Whether 17th-century mathematics books, mid-1940s documents connected with pioneering executives, or the first 1970s-era microcomputers, prices have soared in recent years. Apple Computer's first model, an Apple 1 introduced in 1976 for \$666, now typically fetches \$16,000 to \$20,000 if it's in good condition, says Sellam Ismail, a

BRAINIAC
Edmund Berkeley's
electric brain kit,
circa 1966



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Sandwich generation"

88 | A different approach to
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90 | Take a tour through
Sideways wine country

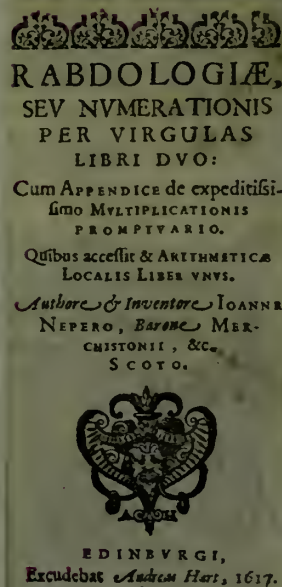
92 | Barker: How does
Dolby's IPO sound?



APPLE ARTIFACT
The first model,
made in 1976,
featured a wood
cabinet



FIRST EDITION
John Napier
described
logarithms in a
1617 treatise



or at the Computer History Museum (computerhistory.org). Christie's estimates the most expensive item in its sale, a 1946 dress plan for the first modern computer company, Electronic Control Co. of Philadelphia, will sell for \$50,000 to \$100,000. The company, a predecessor to Unisys, became famous for its Univac computers. Electronic Control's founders, John Presper Eckert and John Mauchly, were part of the team that built the ENIAC, the first "large-scale general purpose electronic digital computer," according to the Christie's catalog. It weighed 30 tons and contained 18,000 vacuum tubes.

Part of the appeal of computer collectibles is there's something for everybody's budget. Indeed,

the modern computer industry is so new that key items are still widely available and inexpensive. "If you just look into it a little, you can amass a very good collection," says manufacturing consultant George Keremedjiev, who in 1990 founded the American Computer Museum (computerhistory.com) in Bozeman, Mont. For instance, a copy of the famous January, 1975, issue of *Popular Electronics* with a story on the Altair 8800, an early kit computer that helped inspire the founding of Microsoft, still goes for \$100 to \$175, notes Michael Nadeau, author of *Collectible Microcomputers* (Schiffer Books, \$29.95). Brochures for classic home computers such as the

1984 Commodore V364 can be found for \$50 or less, he says, while Christie's figures "Brainiac," a 1966 "electric brain" kit designed by computing pioneer Edmund C. Berkeley, will sell for \$800 to \$1,200.

Most computer collectors are males with a background in engineering. A few major players have tried to document the entire history of computing, such as Bell, who was instrumental in the creation of Digital Equipment Corp. (DEC); Paul Pierce, a retired Intel engineer in Portland, Ore.; and Keremedjiev. Others, such as Microsoft co-founder Paul Allen, focus on specific periods. Not surprisingly, Allen's specialty is the history of microcomputing, and he is donating his collection to the New Mexico Museum of Natural History & Science for an exhibition space that will open in 2006.

ON THE CHEAP

SMALL COLLECTORS TEND to be tinkers. They like to fiddle with old machines, swap parts, recover old software, and get the antiques up and running again. They also collect manuals, brochures, and company documents. The machines aren't really good for very much; the cheapest PC you can buy today has far more power. But

the vintage equipment still attracts a following. Says Wai-Sun Chia, 38, a software engineer with Hewlett-Packard in Kuala Lumpur, Malaysia, who collects vintage DEC minicomputers: "The old machines are more interesting because they were made with boards rather than a single chip. It's like an antique car: You can go inside and figure out what each part does."

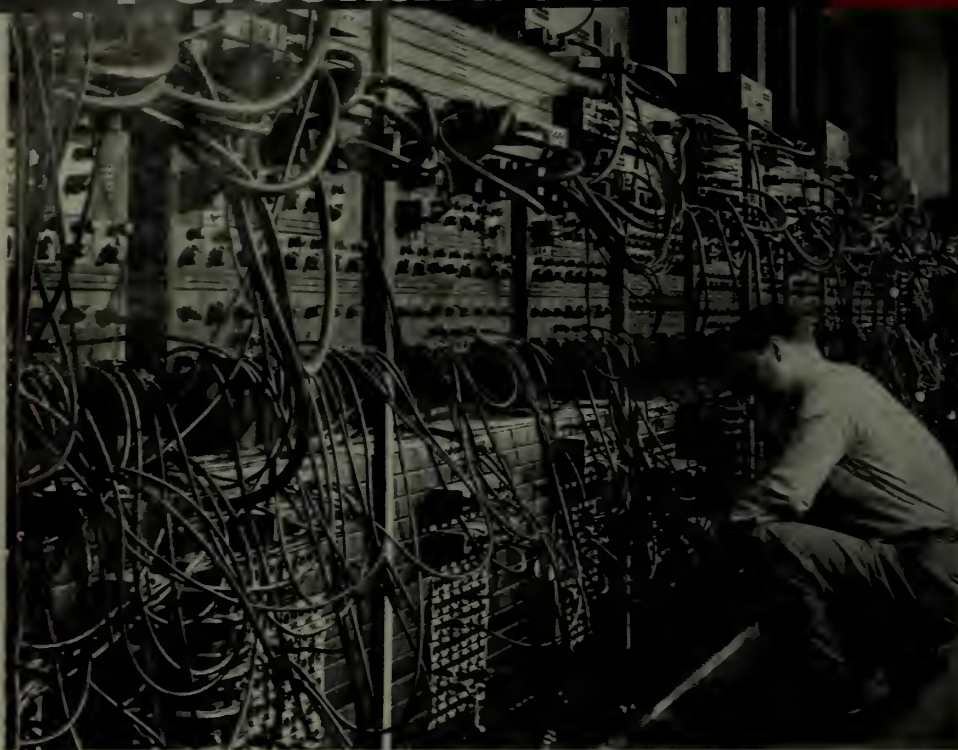
This type of collecting can be remarkably inexpensive. "The deal I've made with my wife is that my collection has to be self-supporting," says Jack Rubin, a suburban Chicago collector who funds new

purchases by trading or selling one of his 50 or so computers. Classic microcomputers such as the Altair 8800, which originally retailed for about \$400 as a kit

BusinessWeek online

For a slideshow on computer memorabilia, and a Q&A with collector Gordon Bell go to businessweek.com/extras

Personal Business



^ **WIRED** ENIAC, the first general-purpose computer, in 1947 and can now fetch up to \$3,000, are getting pricey. But old minicomputers and mainframes can often be had for around \$1,000. Patrick Finnegan, a systems administrator at Purdue University, recently paid \$1,100 on eBay plus \$200 for shipping for a vintage IBM mainframe that cost more than \$1 million new. Storing the bulky old machines is often a collector's main expense: Pierce bought a warehouse to house his collection, considered the largest of its kind in the world outside a museum.

If this hobby appeals to you, it's not hard to get started. If you're mainly interested in historical documents, work with a reputable dealer, such as Uwe Breker in Cologne, Germany (www.breker.com); John Kuenzig in Topsfield, Mass. (kuenzigbooks.com); or Jeremy Norman, the Marin County (Calif.) author and dealer (historyofscience.com) who built the collection Christie's is selling. The Web sites of the two U.S. computer museums and Germany's Heinz Nixdorf MuseumsForum (hnf.de) are also chock-full of historical information.

Some collectors spend a lot of time searching eBay and rummaging around at flea markets, thrift shops,

and computer recycling centers. Two annual events are also invaluable, according to Keremedjiev: Hamvention (hamvention.org), an annual ham-radio flea market in Dayton in late May that he says is "a gold mine of early technology," and the Vintage Computer Festival swapfest (vintage.org) that Ismail puts on every November in Mountain View. Spin-off Vintage Computer Festivals organized by collectors are held in the Midwest, on the East Coast, and in Europe.

Study up before you buy. Seemingly inconsequential details can make all the difference in determining value. Af-

cionados know that a tan vintage Osborne portable is worth more than a gray one because the earlier tan models are much rarer, Keremedjiev says. When it came to DEC's PDP-8 minicomputers, the first ones (dubbed straight 8s) are valued at \$15,000 to \$20,000, while later models fetch only between \$800 and \$3,000, mail says.

If you're careful, "this is a very investment," Keremedjiev contends machines are increasingly hard to find. And more people are becoming aware of the value of computer-related historical material. "I'm stunned," Leonard Kleinrock, a professor at the University of California at Los Angeles computer science professor considered one of the founding fathers of the Internet, upon learning the value Christie's has placed on some of his signed books. It estimates a copy of his first book that he signed for Norman, a dealer he sent the book to years ago, and other items could go to up to 3,500 dollars. In the past, Kleinrock says, he never thought twice about sending his autograph to collectors who asked for it. Those days are probably long gone as the IBM mainframe. ■



^ **CHILD'S PLAY** A French board game designed to teach kids about computing

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Between a Rocker And a High Chair

The Sandwich Generation—caring for both parents and kids—needs a hand. **BY ANDREW PARK**

IN THE MONTHS AFTER MY father had a stroke in 2001 at 71, his garbled speech was nearly as useless as his paralyzed right side. Sometimes, unable to find the words in English, he would lapse into German, the language he had taught to college students for 35 years. Often, he'd struggle to summon a familiar name to his lips. When he tried to say mine, what came out was "Dad."

That name couldn't be more apt. At 34, I'm both a father to two small children and full-time caregiver for my own father. That puts me squarely in the Sandwich Generation—those who care for aging parents while raising their own children. Some 22.4 million U.S. households care for someone over 65. As baby boomers look ahead to old age, with the prospect of remaining there much longer than their parents and grandparents, those numbers are set to soar. According to the National Partnership for Women & Families, 67% of Americans under 60 expect to care for an aged relative in the next 10 years, up from 25% who were caregivers in 1997.

WINGING IT

SADLY, MOST OF US are ill-prepared for the job. Most older Americans lack the means to finance care if they become disabled. Fewer still carry long-term-care insurance. That usually leaves adult children to pick up the pieces, often over long distances. My family is a perfect example. After my mother died in 1999, my dad lived alone and continued to work full-time in Charlotte, N.C., while I lived with my wife, Cristina, in Dallas, and my older brother resided outside Philadelphia. When my dad collapsed on his kitchen floor one Sunday, more than 24 hours passed before a neighbor found him.

In the harrowing days that followed,

my brother and I tried to tally the options available to us, and they seemed few. We were both living far away and in no position to move. Born in Scotland and an only child, my father had no extended family in the U.S. We had no knowledge of the vast landscape of nursing homes and care facilities that could house him and hated the idea of moving him into an institutional setting. Besides, his finances had long been structured to provide for a stable retirement, not sudden disability.

I've since found numerous resources to help adult children care for elderly parents

and cope with the stress (table, p. 10). But we had to wing it, a skill our father taught us years before. Four months after his stroke, he nervously boarded with me to Dallas, where he would live in an assisted living center that offered 24-hour personal care. Several months later, we took the first offer we got for my house to free up cash, storing much of its contents, including thousands of old letters, in file cabinets of old letters.

It turns out these were just the first steps. My dad rehabilitated himself, learning to bathe and dress, ditching his wheelchair for a cane, and augmenting his speech with hand gestures. But as his recovery came a desire to return home. While my brother and I knew we would never enjoy the independence he had before his stroke, I started to think about moving back to the place where he spent most of his adult life made sense. We had many friends in Charlotte, and he could act as a support system for him for us. Our familiarity with the city, coupled with its less hectic pace, would make juggling his care with our own responsibilities easier. So in 2003, my boss at *BusinessWeek* let me relocate from Dallas and telecommute from a home office.

Of course, it wasn't

TOGETHER
Parks of the
generation
Charlotte.





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as easy as we had hoped. We wanted my dad to live with us, to make care easier and save money. But we also wanted the privacy of separate quarters. Suitable houses were scarce, and the cost of building one was out of reach. Once we found one, we had to sink \$3,000 into a chair lift for the steep outdoor stairs. Cristina had her own hill to climb, graciously sharing in our new responsibilities even as she was adjusting to life as a stay-at-home mom.

UNDER STRESS

OTHER CHALLENGES were more mundane. Keeping him fed, his clothes clean, and his medications filled added complication, as did driving him to doctors and therapists. I came to rely on the Red Cross and other groups that offer free rides for senior citizens, and discovered a nearby senior center where he could exercise and eat lunch. My dad learned to make breakfast and administer his drugs. When my wife and I go out of town, we enlist a nursing service that sends aides to cook his meals.

None of this was rocket science, but adding an adult with special needs to a busy household is arduous. Not surprisingly, caregivers are at higher risks of depression, sickness, and financial instability, and two-thirds have to cut back their hours at work or take unpaid leave to maintain their multiple roles.

Still, I would never trade the past three years. It might be because I spent my adolescence watching my parents care for my grandmother the same way. Maybe it's the bond that has grown between my dad and my 2-year-old son, or that my dad and I have spent more time together in the past year than at any time since I left for college in 1989.

This month, we'll celebrate his 75th birthday. While his speech is much better, he still calls me Dad on occasion. I'm not sure why, but I never correct him. ■

Caregiver Assistance

Administration on Aging aoa.gov

Eldercare Locator

800 677-1116 eldercare.gov

Family Caregiver Alliance

800 445-8106 caregiver.org

National Association for

Home Care & Hospice nahc.org

National Association of Professional Geriatric Care Managers

520 881 8008 caremanager.org

Scared to Death Of Life Insurance

Choosing the amount of coverage is hard. The trick is to think like an economist. **BY PETER COY**

LIFE INSURANCE MAY BE the most badly purchased financial product. Some people, unwilling to face the thought of death, never buy coverage at all. Others feel guilty about the prospect of leaving loved ones behind and buy too much. Even those who put their emotions aside tend to fall back on oft-repeated and oft-wrong rules of thumb, such as buying a policy worth five times your annual salary.

Choosing the right amount of life insurance is no easy matter. Even most insurance agents and financial planners rely on rules of thumb or unsophisticated worksheets—or put the onus on clients to decide how much insurance to carry. Fortunately, understanding a few economic principles will go a long way toward helping you make a smart decision.

According to economists, your family's financial goal should be to enjoy the highest standard of living possible over a lifetime. That may mean borrowing when you're young and repaying the loans as you age and earn more. Given your total lifetime income, you don't want to suffer in youth and live high on the hog in old age, or vice versa.

That's where life insurance comes in. If you die, the death benefit to your survivors should be precisely large enough so they enjoy the same living standard as they did while you were alive. Life insurance protects your family if you die young. It goes hand in hand with investing for retirement, which protects you against the opposite risk: that you and your spouse will outlive your savings.

The focus on smoothing consumption over a lifetime leads to some counterintuitive conclusions. It indicates young people are the most likely underinsured, that secondary earners and nonworking spouses are the most likely to be overinsured, and that people should reduce the amount of insurance they carry as they approach retirement. "When it comes to buying insurance, economic man is making major mistakes," economists Jagadeesh Gokhale, a senior fellow at the Center for Retirement Studies, and Laurence Kotlikoff of Boston University wrote in a 2002 paper.

Gokhale and Kotlikoff have done more than advise people for bad decisions. They have distilled their research into a sophisticated program that digests scads of personal data and spits out a multi-year financial plan with annual targets for spending, saving, and insurance coverage. The calculations are so complicated that even a state-of-the-art

takes 15 seconds to produce a result. The \$149 program, ESPlanner, is sold by a company that Kotlikoff helped found, Economic Security Planning Inc. in Boston, Mass. (esplanner.com).

Even if you don't buy the program, you can learn a lot by looking at life insurance through an economic lens. Start with what economic theory says about the young. Many people who are starting families buy a little life insurance coverage, then add more as their incomes increase and they can afford more protection. That's the opposite of what you should do. You want the most coverage when you have just started a family, because the insurance has to cover decades

Set it up so that your family's lifestyle won't be diminished



Life Insurance: A **Better** Approach

To determine how much life insurance a hypothetical family of four should buy, we turned to ESPlanner, a program developed by economists. We first assume Joe, 30, earns \$100,000 a year; Sue, 28, makes \$50,000. Their children are 3 and 1. Their earnings rise 1% a year after inflation, and their investments, now worth \$100,000, earn 3% a year after inflation. They plan to retire at 65 and expect to live until 95. They own a house and are saving for their children's education.

SCENARIO	JOE'S POLICY	SUE'S POLICY	EXPLANATION
The family's initial status	\$1,200,000	\$280,000	Sue needs less insurance than Joe because she earns less. Part of her policy would cover the cost of an au pair if she dies.
They have \$300,000 in assets instead of \$100,000	1,100,000	210,000	The extra \$200,000 in assets partially substitutes for life insurance. But coverage doesn't decline as much as assets rise because the family needs to insure a richer lifestyle.
They have another baby	1,200,000	270,000	Small impact. The family tightens its belt when the baby arrives, so overall spending that must be covered barely changes.
They expect to live to 90, not 95	1,200,000	270,000	Small impact. Joe and Sue have fewer years of life to cover with insurance, but they will spend more each year.

Data: ESPlanner, BusinessWeek

of future earnings that will be lost if you die. As you get older, you can afford to decrease coverage because you have fewer years of earnings to make up for, your spouse has more assets to live off of and fewer years of life remaining, and your children are closer to being on their own.

YOUNG IDEA

THOSE FACTORS HAVE big implications for what kind of insurance is appropriate. Insurance agents often advocate cash-value policies because they double as investment vehicles. With simple term insurance, they argue, you're left with nothing to show for your years of premium payments. That's true. But the only way most young people can afford to buy as much life insurance as economic theory says they need is to opt for term policies that pay a death benefit and nothing more. A 25-year-old can buy a \$2 million, 30-year policy from a reputable insurer for about \$1,600 a year. That same premium would buy a death benefit of only a quarter as much—\$500,000—if it were put into a variable universal life policy that has an investment feature. Younger people should place protecting future income ahead of piling up savings, but many succumb to agents' sales pitches for cash-value policies. According to the latest available numbers from the American Council of Life Insurers, whole, universal, and variable life policies account for 84% of premiums, vs. only 16% for term policies.

Thinking like an economist can sometimes lead you to buy less insurance, not more. In ESPlanner's software, secondary earners often require little or no life insurance, even taking into account that the secondary earner (most often the wife) often provides essential services that must be replaced, such as child care. Why? Mainly because child care is a relatively short-term issue. When the secondary earner is gone, the need to support that person until, say, age 95 is gone, too.

If you want to follow economists' advice and reduce your coverage as you approach retirement, inflation will take care of part of your problem by eroding the real value of your death benefit. A \$2 million policy will be worth just \$1.1 million in today's dollars in 20 years, assuming 3% inflation. Also, some insurers offer policies that have level premiums but declining coverage over time.

A good way to shrink your coverage over time is to buy policies of different durations and layer them. If you want to start with \$1.5 million in coverage and then have it decline, buy three \$500,000 policies. Make the first expire after 10 years, the second after 20, and the third after 30 years. That will give you a smoothly declining amount of coverage as you glide toward retirement.

No one enjoys buying life insurance. But if you think like an economist, you can come away feeling like you've at least correctly calculated the odds. ■

Sideways in Santa Barbara

Follow in the film's footsteps by touring the region's family-owned wineries. **BY CHRISTOPHER PALMERI**



IT HAS LONG BEEN ONE OF California's best-kept secrets. Just a two-hour drive north of Los Angeles, Santa Barbara's wine country lies amid cow pastures, mountains awash in greenery, spectacular ocean vistas, and sunlight that plays upon the landscape like an Impressionist painting. The hit film *Sideways*, nominated for the best picture Oscar, has sparked a boom in tourism to the region. Despite all the attention, a trip to Santa Barbara's vineyards remains an easy-to-manage getaway.

Fans of the film, which chronicles a week-long roadtrip for two former college roommates, a struggling actor Jack (Thomas Haden Church) and a struggling writer Miles (Paul Giamatti), can download a free map of the real-life locations at santabarbaraca.com.



The Hitching Post Restaurant, where oenophile Miles meets his love interest Maya, lives up to its cameo with excellent steaks and the house label Highliner pinot noir featured in the movie. So does the Kalyra Winery, where Jack, who's celebrating his last week of bachelor-

hood, picks up wine pourer St. On a recent Saturday afternoon was hopping, with rock music and a youthful staff cracking j-shirts for sale read "Get Sideways lyra Winery." The best bets dessert wines, such as the fruity too sweet 2003 Orange Muscat.

Unlike Napa and Sonoma, it and better-known neighbors north, Santa Barbara's wine doesn't take itself too seriously. the more than 70 wineries are family affairs. Blessed with a climate that allows its grapes to stay vine longer than in other regions, Barbara is noted for its difficult-to-pinot noirs, a rich and versatile variety enjoying a surge in popularity thanks to the movie.

"JUST A FLUTTER"

TWO LOCAL establishments with reputations for pinots are Foxen and Sanford Winery. Both operating rooms in old wooden barns. *Spectator* magazine described Foxen facility as "rustic at best." But that stopped either from scoring well on national surveys. Sanford's 2002 Noir-Vin Gris earned 90 points out of 100 from the *PinotReport* website (pinotreport.com). It's the wine in Miles smells citrus, strawberry, pear fruit, "the faintest *soupçon* of asparagus, and just a flutter of like a Edam cheese" in one of the film's scenes. Foxen co-founder Dick notes the challenges of making pinot noir, including a thin-skinned grape conducive to moisture and oxidation that can destroy

TASTINGS
Giamatti and Church in *Sideways*; Fess Parker's winery

wine's structure.

Doré: "You tiptoe the barrels."

Other standout pinot noirs are produced by Fess Parker Winery & Vineyard.

Called "Frass Canyon" in the movie where a despondent Miles drinks from the spit bucket. Parker's no stranger to show business: He played Davy Crockett in the hit 1950s television show. Today, he sells coonskin caps in his winery and owns the elegant Wine Country Inn & Spa in the charming and centrally located village of Los Olivos. "I'm fascinated by the ocean and the mountains," the native Texan says of his tour of the area six decades ago. "I haven't been able to get away." Take your own *Sideways* tour and you'll see what he means. ■

ED BY TODDI GUTNER

CTRONICS

OM YOUR ONE TO THE MAILBOX

NOW YOU CAN USE a camera phone to send picture postcards the old-fashioned way—by mail. Cingular subscribers with newer **Motorola** phones can snap a picture, type in a short note and an address, and zip it off. For \$1.99, **Fuji Photo Film** prints

the card, affixes a stamp, and mails where in the U.S. **Verizon** has a deal with online photo service **erfly**, but it works only with a **ra KX2** phone. —Larry Armstrong

IE OFF

REAMY DALI PHILADELPHIA

U'RE A FAN OF Surrealist art, get self to Philly in the next three ths. From Feb. 16 to May 15 the **delphia Museum of Art** will be the U.S. venue to host a major perspective of works by the quirky and ential 20th century Spanish artist **ador Dalí**. The show, celebrating the enary of Dalí's birth, will feature paintings as well as multimedia es, such as the painted plastic, ter, and metal **Lobster Telephone** own here), films including the orious *Un Chien Andalou*, and ings. The 200 works have been overed from public and private ections in 14 countries. Tickets cost for adults, \$17 for seniors and lents, \$10 for children 5 to 12 (215 -SHOW or philamuseum.org).



REAL ESTATE

Sold—Too Soon

DID YOU EVER PUT A HOME on the market and wonder if the real estate agent pushed a little too hard to sell instead of holding off for a better deal? If so, you were right to be suspicious, conclude **University of Chicago** economists Steven Levitt and Chad Syverson in their just-released study “Market Distortions When Agents Are Better Informed.” They surmised that real estate pros pressure clients into selling too cheaply and quickly, since agents get their commission when the deal closes. If they wait for a higher offer, they pocket only a sliver of any incremental profit.

To test their intuition, the authors compared home sales made by agents on behalf of clients with instances when agents sold their own houses. It turns out agents did well—for themselves. They kept their own houses on the market roughly 10 days longer than their customers' and earned an average 3.7% more on the sale. The professors wonder why more people don't hire appraisers to value their homes. Since appraisers have no stake in when or whether the house is sold, their opinions may give sellers a better idea of what price to hold out for.

—Christopher Farrell

CONSUMER CREDIT

SAVE YOURSELF separate phone calls if you want a free copy of your credit reports once a year, as now allowed by federal law. At www.annualcreditreport.com, you can make

requests of each of the three main credit reporting agencies, **Equifax**, **TransUnion**, and **Experian**. The law is in effect for residents of 13 Western states, then it phases in regionally through September. A good strategy is to ask for one report from a different agency every four months. That makes it easier to spot suspicious activity over the course of a year.





BY ROBERT BARKER

Dolby's IPO: Are the Numbers Distorted?

Hindsight, we all know, is 20-20. It's also frustratingly ineffective. Despite much mature retrospection, I can't unsay those mean comments to Mom, undo what 18 years of smoking did to my lungs, nor unwrite the cringe-inducing history of my high school social life. If only I were selling stock to the public.

What prompts this wistful detour is the initial public offering of stock in Dolby Laboratories, the San Francisco audio-engineering company whose handiwork in the 1970s made cassette tapes worth hearing. After that, its work on film soundtracks surrounded us at almost every movie (up soon, DreamWorks' next animated feature, *Madagascar*). Sales of home-theater gear are boosting the royalties Dolby gets on sales of DVD players and such, which use its software. For the future, it's counting on helping Hollywood switch from celluloid to digital films. Closely held since its founding in 1965, Dolby aims soon to go public in a \$399 million deal.

EXPECT DOLBY TO GET a warm reception. With a history of innovation and its recent performance—33% sales growth in fiscal 2004 ended September, to \$289 million; operating profit up 39%, to \$105 million—the company is as well seasoned as technology IPOs come. If the deal comes at the estimated \$14.50 a share, then Dolby would command a market value of 22 times its past four quarters' profit (table). That's hardly a Googlacious (136 times) multiple, and it's sharply below the 28 times earnings of a leading rival, Digital Theater Systems. Fair minds might argue that Dolby's better-known brand and its size—revenues run six times DTS'—merit a higher multiple.

Yet the first question—and here's where Dolby's 20-20 retrospection comes in—is: Just what were the earnings? To see what I mean, you might search Dolby's latest registration statement for the key words "restatement" and "hindsight." Two curiosities emerge. First, after consulting with its underwriters, Dolby found that its own assessments of the company's value, made in close consultation with an independent appraiser in July, 2003, and again last July, were way low. Second, Dolby changed how it reckoned the cost of its



MADAGASCAR Dolby movie sound is solid. But its earnings figures may be shaky

employee stock options—in the boosting past and future profits.

Dolby in fiscal 2004 granted nearly 5.4 million stock options at an exercise price of \$2.08 a share. Based on its outside appraiser's reports, it at the same time declared that \$2.08 a share was the company's value. Private companies can be worth less since their stock isn't easily traded, but \$2.08 is obviously way below the \$14.50 Dolby's underwriters think the stock will fetch in the IPO. So, the accountants had to figure out how much of the gap should be recognized as pay and be deducted from earnings. When it filed its first set of pre-IPO financials in November, Dolby put that cost at nearly \$59 million.

Now, Dolby has changed its mind. It decided to alter the assumptions and methods used by its valuation consultant. On Jan. 31, it issued new financials showing fiscal 2004 stock option expense costing \$38 million, a drop of more than \$20 million. Because accounting rules require the expense to be spread over the years that the options vest, Dolby's fresh estimate of its value lowered its fiscal 2004 compensation costs to \$7.3 million. In the current and the next two fiscal years, Dolby's revision could add perhaps a nickel a share to net income.

Dolby may have good reasons for this late accounting change. A spokesman, however, told me that ahead of the IPO it's resting on securities filings. There, Dolby noted, "reassessed values are inherently uncertain and highly subjective." So are its earnings.

E-mail: rb@businessweek.com

Decoding Dolby

Revenue	\$308
Operating income	\$106
Net income	\$63
Total debt	\$15
Cash	\$94
Indicated equity value	\$1,412
Ticker symbol	DLB*

Dollars in millions, pro forma for operation as public company, for 12 months ended Dec. 31, 2004; balance sheet data also as of that date but not adjusted for IPO.

* Tentative

Data: Company reports



BY GENE G. MARCIAL

A REBOUND IN AIRCRAFT ORDERS MAY BE JUST AHEAD AT **BOEING**.

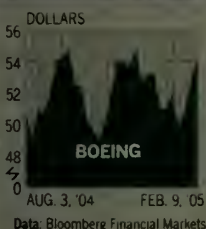
SABRE'S PARTS ARE WORTH MORE THAN ITS STOCK, SOME SAY.

IS BETTER NEWS COMING ON **IRIDEX'** OPHTHALMIC TREATMENTS?

Clearer Skies for Boeing?

AEROSPACE GIANT BOEING (BA) has been struggling to gain altitude since September when it was at 55 a share; it's now at 54. Although the No. 2 commercial jet posted improved fourth-quarter earnings, the Street was unimpressed. The slack in demand from the big airlines, tougher competition from No. 1 Airbus, and a sharp growth in defense spending weighing down the stock. But investors see Boeing as a coming buy. "In 18 months, Boeing will be going high in the commercial aircraft market [40% of sales], when we have a strong flow of orders" from Asian widebody carriers, says Gordon Lerner, chief investment officer at Parnassus Fund Management, which owns shares in Boeing's 5 billion portfolio. China, India, and Japan are ready for more aircraft, he says, as well as Saudi Arabia and the United Arab Emirates. Peter Zuleba III, senior portfolio manager at Parnassus, says investors have yet to focus on Boeing's lush cash flow (operating cash less capital expenditures) and improving profit margins. Free cash flow of \$2.1 billion in 2004 should jump to \$3.5 billion in 2005, says Zuleba, who expects Boeing easily hitting 60 by yearend. Operating margins, he expects, will rise to 6.5% in 2005 and to 7.5% in 2006, up from 2004's 3.6%. Byron Callan of Merrill Lynch (it did downgrade Boeing), although neutral on the stock, expects a jump in 2006 profits, to \$3.40 a share, from \$2.65 a share this year. He agrees cash flow is Boeing's strong suit.

NOT YET IN THE CLEAR

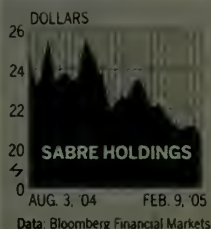


(71% of sales) is worth \$17.72 a share; Travelocity, the sole provider of travel services to those who book through America Online's and Yahoo!'s sites (18%), \$10.50; Sabre Airline Solutions, a software provider to airlines and travel operators (11%), \$1.54; plus cash net of debt, \$2.27. Scott Barry of Credit Suisse First Boston (which did business with Sabre) forecasts earnings of \$1.48 in 2005, up from 2004's \$1.38. He rates the stock a "hold."

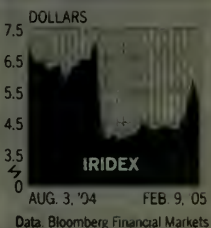
Iridex May Open More Investors' Eyes

NOTHING HURTS A STOCK MORE than disappointing results—from earnings or a new drug or medical product. That's what torpedoed Iridex (IRIX), a maker of laser systems to treat eye ailments: It dived from 7.19 on Oct. 20 to 3.95 within days after initial results of clinical trials on Iridex' TTT (transpupillary thermotherapy) product—for age-related [wet] macular degeneration (AMD), a leading cause of blindness—disappointed investors. Dr. Elias Reichel, an ophthalmology professor at Tufts University School of Medicine and chief of the two-year trial, said further analysis of the results was needed: He called the 47% of patients responding positively to TTT "statistically insignificant" compared with the placebo group. Larry Haimovitch, whose medical technology consulting firm owns shares, expects a more favorable interpretation of the data when Reichel elaborates on the study at a Macula Society conference in Key Biscayne, Fla., on Feb. 25. And recently the stock has spiked, to 5. John Porter of Arabella Securities sees it earning 24¢ a share in 2005 on sales of \$35.5 million, and 35¢ in 2006 on 38.4 million. Haimovitch is predicting the stock price will double in 12 months. ■

BADLY BEATEN DOWN



A SETBACK IN THE TRIALS



Why Sabre Could Be in Better Places

COTT KUENSELL, managing director at Brandywine Asset Management, is always on the lookout for beaten-down companies with valuable assets. He thinks he sees it in the now not-so-hot travel business, Sabre Holdings (SABR). Kuensell bought shares in October as they fell from 26 to 20. Why? He believes the assets are worth more than Sabre's stock price, based on recent deals, including the buyout of Orbitz in 2004. Spun off in 2000 by AMR, American Airlines' parent, Sabre has become a major travel technology provider. Kuensell estimates Sabre's three units are worth 32 a share: He figures its travel network that provides bookings

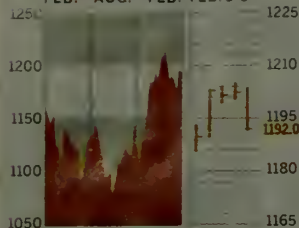
BusinessWeek online Gene Marcial's Inside Wall Street is posted at businessweek.com/today.htm at 5 p.m. EST on the magazine's publication day, usually Thursdays.

Note: Unless otherwise noted, neither the sources cited in Inside Wall Street nor their firms hold positions in the stocks under discussion. Similarly, they have no investment banking or other financial relationships with them.

STOCKS

S&P 500

FEB. AUG. FEB. FEB. 3-9



COMMENTARY

HP shares surged on hopes of a breakup after CEO Carly Fiorina's ouster on Feb. 9. The overall market was less sunny and stocks fell. Tech stocks are in a funk: Cisco fell despite a 93% hike in earnings. Yields on 10-year Treasuries slid below 4%. Looking past the day-to-day jitters, the main indexes traded in a narrow range, suggesting that investors are in wait-and-see mode.

Data: Bloomberg Financial Markets, Reuters

U.S. MARKETS

	FEB. 9	WEEK	% CHANGE YEAR TO DATE	LAST 12 MONTHS
S&P 500	1192.0	-0.1	-1.6	4.6
Dow Jones Industrials	10,664.1	0.6	-1.1	0.8
NASDAQ Composite	2052.6	-1.1	-5.6	-0.4
S&P MidCap 400	653.7	-0.1	-1.5	9.5
S&P SmallCap 600	324.3	-0.5	-1.4	15.5
DJ Wilshire 5000	11,734.3	-0.2	-1.8	5.6

SECTORS

			% CHANGE YEAR TO DATE	LAST 12 MONTHS
BusinessWeek 50*	703.4	0.3	-0.2	10.6
BW Info Tech 100**	357.1	-0.4	-4.3	-0.4
S&P/BARRA Growth	571.5	-0.4	-1.8	0.1
S&P/BARRA Value	616.2	0.2	-1.5	9.2
S&P Energy	310.9	1.4	7.7	37.0
S&P Financials	405.9	0.1	-1.3	2.9
S&P REIT	137.3	2.2	-5.0	12.4
S&P Transportation	219.2	-1.0	-9.2	13.6
S&P Utilities	147.2	0.9	4.0	22.7
GSTI Internet	158.8	-5.1	-10.9	7.4
PSE Technology	744.2	-0.4	-4.5	1.2

*Mar. 19, 1999=1000 **Feb. 7, 2000=1000

GLOBAL MARKETS

	FEB. 9	WEEK	% CHANGE YEAR TO DATE
S&P Euro Plus (U.S. Dollar)	1357.5	-0.6	-2.1
London (FT-SE 100)	4990.4	1.5	3.1
Paris (CAC 40)	3969.6	0.5	3.1
Frankfurt (DAX)	4353.2	1.3	2.3
Tokyo (NIKKEI 225)	11,473.4	0.6	-0.1
Hong Kong (Hang Seng)	13,845.6	2.1	-2.1
Toronto (S&P/TSX Composite)	9402.6	1.1	1.1
Mexico City (IPC)	13,662.4	2.4	5.8

FUNDAMENTALS

	FEB. 8	WEEK AGO
S&P 500 Dividend Yield	1.93%	1.93%
S&P 500 P/E Ratio (Trailing 12 mos.)	19.6	19.6
S&P 500 P/E Ratio (Next 12 mos.)*	16.3	16.2
First Call Earnings Surprise*	4.13%	4.19%

TECHNICAL INDICATORS

	FEB. 8	WEEK AGO
S&P 500 200-day average	1136.6	1135.0
Stocks above 200-day average	76.0%	74.0%
Options: Put/call ratio	0.70	0.73
Insiders: Vickers NYSE Sell/buy ratio	4.31	4.52

BEST-PERFORMING GROUPS

	LAST MONTH %		LAST 12 MONTHS %
Constr. & Engineering	18.5	Fertilizers & Ag. Chems.	73.9
Oil & Gas Refining	16.8	Steel	68.5
Homebuilding	15.2	Oil & Gas Refining	68.0
Oil & Gas Drilling	11.7	Managed Health Care	49.6
Integrated Oil & Gas	11.5	Homebuilding	48.7

WORST-PERFORMING GROUPS

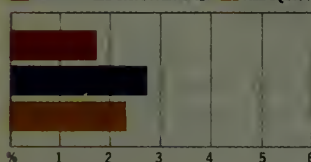
	LAST MONTH %		LAST 12 MONTHS %
Internet Retail	-25.9	IT Consulting	
IT Consulting	-18.4	Electric Mfg. Svcs.	
Communication Equip.	-9.0	Semiconductor Equip.	
Automobiles	-8.5	Insurance Brokers	
Airlines	-8.4	Semiconductors	

MUTUAL FUNDS

4-WEEK TOTAL RETURN

WEEK ENDED FEB. 8

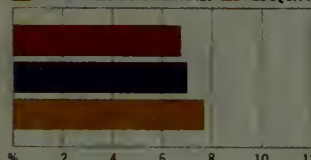
■ S&P 500 ■ U.S. DIVERSIFIED ■ ALL EQUITY



52-WEEK TOTAL RETURN

WEEK ENDED FEB. 8

■ S&P 500 ■ U.S. DIVERSIFIED ■ ALL EQUITY



Data: Standard & Poor's

EQUITY FUND CATEGORIES

4-WEEK TOTAL RETURN	%	52-WEEK TOTAL RETURN	%
LEADERS		LEADERS	
Latin America	11.4	Latin America	38.4
Natural Resources	8.7	Natural Resources	33.1
Diversified Emerg. Mkts.	6.0	Utilities	22.7
Utilities	5.6	Real Estate	19.1
LAGGARDS		LAGGARDS	
Precious Metals	-3.8	Precious Metals	-10.1
Japan	-1.8	Technology	-7.2
Communications	0.1	Health	0.8
Health	0.2	Large-cap Growth	2.5

EQUITY FUNDS

4-WEEK TOTAL RETURN	%	52-WEEK TOTAL RETURN	%
LEADERS		LEADERS	
ProFunds Oil & Gas Inv.	17.2	ProFunds Oil & Gas Inv.	56.6
CGM Capital Development	15.4	BlackRock Gl. Res. Inv. A	54.0
Third Millennium Russia	14.0	CGM Realty	50.5
CGM Focus	13.0	Alpine U.S. RI. Est. Eq. Y	48.2
LAGGARDS		LAGGARDS	
ProFunds Pr. Mtls. Inv.	-9.4	Ameritor Investment	-45.7
ProFds. USh. Mid Cap Inv	-8.4	ProFunds Semicdr. Inv.	-35.8
ProFds. USh. Sm. Cap Inv.	-8.4	Apex Mid Cap Growth	-30.8
ProFds. Intnet. Ulstr. Inv.	-7.7	Van Wagoner Sm. Cap. Gr.	-28.9

INTEREST RATES

KEY RATES

	FEB. 9	WEEK AGO
Money Market Funds	1.95%	1.90%
90-Day Treasury Bills	2.52	2.50
2-Year Treasury Notes	3.25	3.32
10-Year Treasury Notes	3.98	4.14
30-Year Treasury Bonds	4.37	4.58
30-Year Fixed Mortgage†	5.60	5.60

†BancQuo

BLOOMBERG MUNI YIELD EQUIVALENTS

Taxable equivalent yields on AAA-rated, tax-exempt municipal bonds, assuming a 30% federal tax rate.

	10-YR. BONO	30-YR. BONO
General Obligations	3.42	4.42
Taxable Equivalent	4.90	6.32
Insured Revenue Bonds	3.59	4.59
Taxable Equivalent	5.13	6.43

THE WEEK AHEAD

RETAIL SALES Tuesday, Feb. 15, 8:30 a.m. EST » January retail sales probably slipped 0.2% after a hefty December gain of 1.2%. That's based on the median forecast of economists surveyed by Action Economics LLC. Excluding vehicles, sales most likely posted a 0.4% increase, after a 0.3% gain in December.

BUSINESS INVENTORIES

Tuesday, Feb. 15, 10 a.m. EST » December inventories

probably climbed another 0.3%, after a 1% increase in November.

INDUSTRIAL PRODUCTION

Wednesday, Feb. 16, 9:15 a.m. EST » Industrial output is forecast to have expanded by 0.3% in January, following a 0.8% jump in the prior month. The average operating rate probably rose to 79.4%, from 79.2% in December.

EXPORT-IMPORT PRICES

Thursday, Feb. 17, 8:30 a.m. EST » January export prices most

likely moved up 0.2% for a second consecutive month. Import prices probably rebounded with a 0.6% increase, following an oil-driven 1.3% decline in December.

PRODUCER PRICE INDEX

Friday, Feb. 18, 8:30 a.m. EST » January producer prices are expected to have risen 0.3%, after a 0.7% drop in December. Minus food and energy, core prices most likely grew by 0.2%, after a 0.1% gain in December.

The *BusinessWeek* production dropped to 239.1 for the week ending Jan. 29, but remained 12.4% above the previous-year level. Based on calculation of the four-week moving average, the index fell to 236.2.

BusinessWeek online

For the BW50, more investment data, and the components of the production index visit www.businessweek.com/magazine/extra

Companies

Index gives the starting page for a story or feature with significant reference to a company. Most subsidiaries listed under their own names. Companies listed only as subsidiaries are not included.

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Now Who'll Save Hewlett-Packard?

THEY WERE TWO YOUNG Stanford University graduates—one a dyslexic technical genius, the other a star athlete from a hardscrabble Colorado town. They set up shop in a one-car garage in 1938 and built a Silicon Valley icon, Hewlett-Packard Co., an innovation machine that pioneered radar, computers, and other digital wonders.

She was the most popular and powerful businesswoman of her time, a brilliant salesperson, convinced she could help rescue the company that had lost its way. William R. Hewlett and David Packard were as modest as Carleton S. Fiorina is flashy, as tech-driven as she is market-focused. Of all the errors made in Fiorina's six-year tenure as CEO of HP, none is perhaps as important as the notion that an outsider with values and skills vastly different from those of HP's founders could revive a company with a culture that so embodied their engineering-driven personalities (page 28).

Yes, of course, Louis V. Gerstner Jr. did just that with IBM. A marketing specialist from outside the computer industry, he rescued another declining digital behemoth by defying calls from Wall Street to split up the company to release shareholder value. But Carly was no Lou. He had gained the respect and loyalty of IBMers early by going to the IBM Research labs upon taking office, recognizing and celebrating IBM's core technology culture. Carly was never able to win the loyalty of HP's employees, who mostly resented and resisted

her until the day she was ousted by the board of directors.

Gerstner was also totally in control. He may have ruled by fear, but he spent his first three years fixing the plumbing of IBM, and in the end he was in control of its operating units. Carly tried her hand at reorganization, but it never really worked. HP's board felt that she wasn't good enough

Fiorina lacked the magic Gerstner brought to IBM

at operations, and Carly stubbornly refused to hire a new operating officer.

Gerstner disparaged the "vision thing," yet he created a powerful, overarching strategy for IBM—one that moved the company up to high-end services. He sold IBM's technical abilities as solutions to Corporate America's info tech problems. Fiorina's strategy of merging a low-end computer maker, Compaq, failed to create a

clear strategy for HP. She tried to serve too many customers in too many markets: consumer electronics, commodity PCs, valued enterprise businesses, and, of course, printing. In the end, IBM dominated high-end computer services, Dell controlled low-end PCs, and only HP's printing operation made real profits. Faced with new competition from Dell, even printing is now under fire. The merger with Compaq, while executed smoothly by Fiorina, never delivered on raising margins or profits.

Which is what Walter Hewlett, the eldest son of founder William Hewlett, predicted when he fought Fiorina's purchase of Compaq in 2002. He rallied the descendants of both founding families—and the shares they controlled personally and through foundations—in the failed proxy battle. The board asked him to leave for his efforts. Perhaps they should ask him back. Carly was hired to help revive a flagging high-tech pioneer. Someone still needs to save HP.

Mooching Off Medicaid

BLAME THE MIDDLE class for many of Medicaid's problems. Harsh as that sounds, the state-run medical-care programs originally designed to help poor mothers and their children now increasingly pay for nursing-home care for seniors. While many of those seniors are genuinely poor, others are not. They have simply shifted their savings and assets to relatives—faking poverty and getting Medicaid and taxpayers to shoulder their long-term nursing-home costs. While this may be legal, it is surely not moral. It

is also fiscally ruinous. President Bush's budgetary proposal to cut \$60 billion out of Medicaid over the next decade is driven in part by the explosion in nursing-home costs. Tightening up Medicaid eligibility rules, as well as expanding the long-term-care insurance market, can save a portion of those cuts for those who deserve it: the truly poor (page 5).

Check out the numbers. Medicaid costs already absorb 22% of state budgets, twice the portion spent on higher education. Only about 9% of those enrolled in Medicaid are seniors, but they claimed 26% of the program's budget, almost all for nursing-home expenses. Medicaid already pays more than 60% of the country's bill for nursing homes. And this can only get worse as baby boomers start to retire.

It's time for state and federal governments to step up. Savings are supposed to pay for a person's old age, not be given to children leaving taxpayers to pick up the burden. Demand for asset-shifting is so great in retirement communities that lawyers provide ready assistance. Virginia plans to examine financial statements for the six years before people apply for Medicaid, up from the current three. Other states should follow suit.



Hill Companies

BusinessWeek

005

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PFIZER'S FUNK

HANK McKINNELL helped pioneer the age of blockbuster drugs. But a dearth of new products and fears over drug safety are hurting the entire industry. Is there a fix?

BY AMY BARRETT (P.72)

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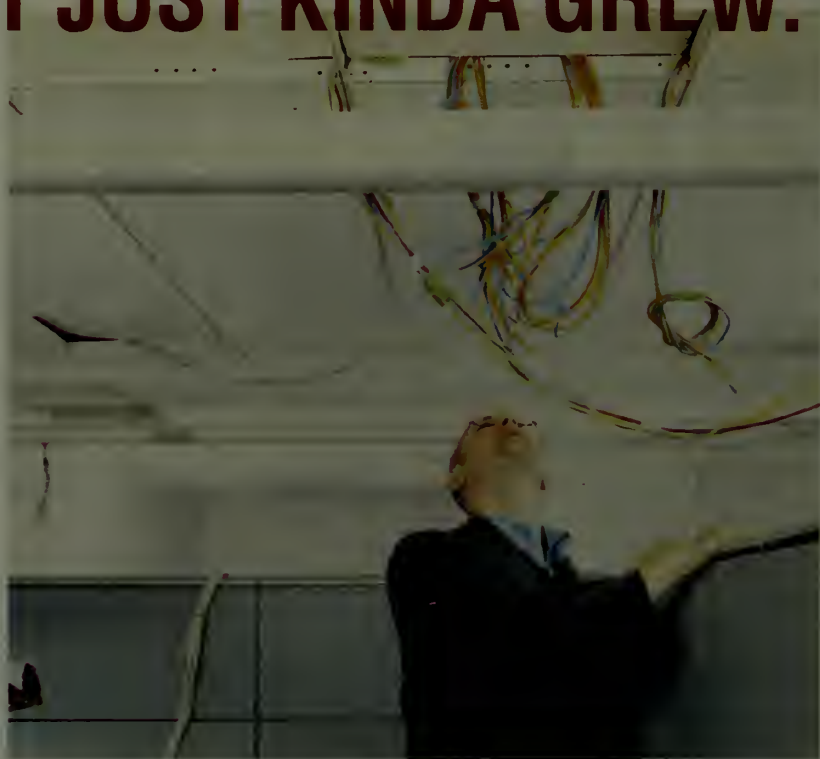
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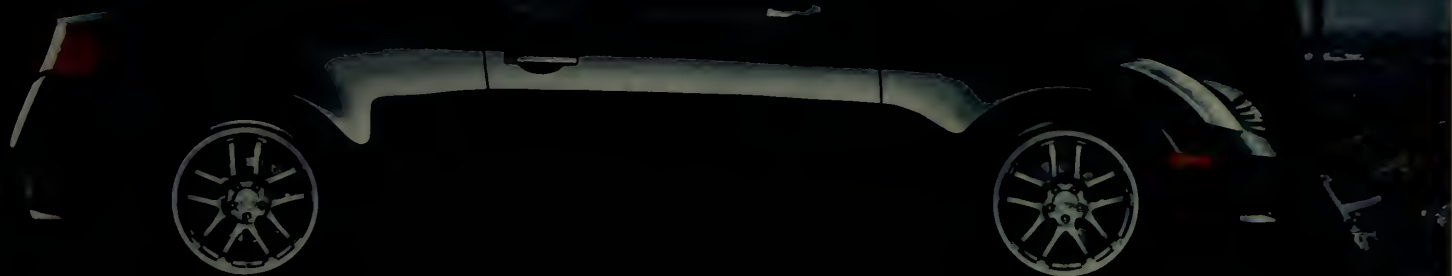
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"HENDRICK'S WON

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FRIDAY, AUGUST 29, 2005 - VOL. CCLXII NO. 41 - ***** \$1.00

When it came to our tasting of "white goods," the superpremiums ruled the day. Here, our top three in each category, plus our tasters' comments:

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\$30/750ml Flavorful

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Juniper Green Best
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\$26.50/750ml



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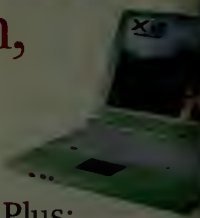
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Special Report: I Am Woman, Hear Me Shop

Rising female consumer power is changing the way companies design, make, and market goods—and it's about more than adding pastels. Plus: A slide show of new products reflecting that influence



The Budget's Misguided Parsimony

Cuts in R&D and education spending in the Bush Administration proposed 2006 budget are shortsighted, says *BusinessWeek* Chief Economist Michael Mandel. They'll hurt multifactor productivity, a little-known but key force behind U.S. economic oomph

Special Report: So, What the Heck Are Web Services?

A good question, and it raises lots of others. Here are some straight answers about this critical new movement in computing. Plus: Small players who could go big, and fulfilling Bill Gates's vision at Microsoft



The Lowdown on High-Tech Trends

In a Q&A, Forrester Research CEO George Colony discusses what's really driving information technology, and what's overblown. He deflates outsourcing, predicts Net links for billions of products, and sees GM's CIO Ralph Szygenda as a pioneer

The New Boss Behind the Wheel at Toyota

By slamming the brakes on costs, incoming chief Katsuaki Watanabe put his career—and the carmaker's profits—in the fast lane



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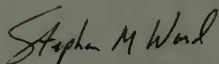
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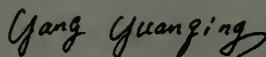
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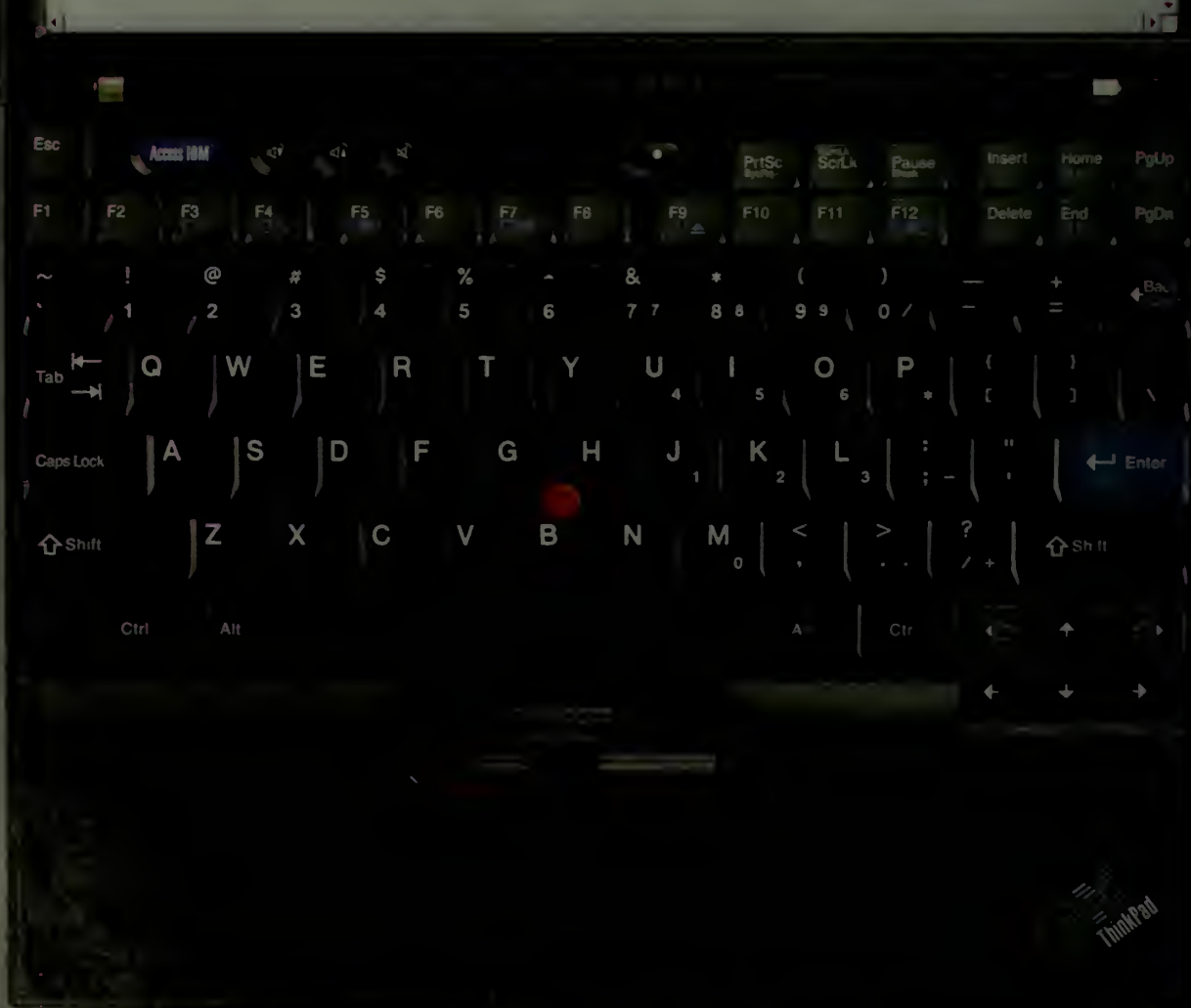


Stephen M. Ward, Jr.
Proposed CEO of Lenovo Group



Yang Yuanqing
Proposed Chairman of Lenovo Group

ONLY ON A THINKPAD.



JP

Front

"I think you have to do it in a cautious, gradual way."

—Alan Greenspan, on the right way to introduce private social security accounts, which he supports

D BY IRA SAGER

PHARMACOLOGY

NEW TEETH FOR A DRUG WATCHDOG

REGULATION that goes into effect in November will give Europe's drug agency new powers—in some cases, exceeding those of the

U.S. agency, the FDA. The new powers include the ability to impose civil risk fines of up to 10% of their annual revenue. "This is an important new power the FDA does not possess," says Linda Horton, a former FDA official and now a partner at the Brussels law firm **Hogan & Hartson**. The agency will also have the power to yank a medicine from the market not only if it proves harmful but also if clinical evidence indicates the drug is less effective than previously thought.

One question that still lingers is whether the European agency will exercise its new powers to take on Big Pharma. The agency gets 70% of its \$144 million budget from fees paid by the pharmaceutical companies for approval applications.

Industry fees provide only 44% of the \$590 million the FDA spends on its two centers that review drugs.

—Kerry Capell, with John Carey



Food & Drug Administration. Under the new rules, the European

BEXTRA One of the Cox-2 drugs under review

Medicines Agency can demand more studies from drug-makers if concerns about a product's safety or effectiveness emerge after it's on the market. Companies that don't



WRETCHED EXCESS

They're Opting Out of Options

U.S. BUSINESSES are beginning to kick the options habit. Companies have sobered up to new rules, which take effect in June, requiring that they treat stock options as an expense. The number of new grants at America's 200 largest companies declined for the third straight year in 2003, with nearly two out of three companies cutting back. Compensation experts say that trend continued through 2004 and will accelerate in 2005.

Companies are replacing options in various ways. Several, such as **Progress Energy**, are replacing some or all of their options with fewer shares of restricted stock. Others are simply reducing option grants without offering a replacement. That's the case at **Dell**, where employees got 51 million options in 2004, down from 126 million two years earlier.

Reining in options may help curb out-of-control executive pay, as companies axe "mega-grants" worth more than \$10 million and "evergreen" provisions that replace options as they are exercised. Consultancy **Pearl Meyer & Partners** says 92 of the 200 largest companies gave mega-grants in 2004, down from 130 in 2002. Five companies got rid of evergreen provisions in 2004, leaving just 22 with them. —Louis Lavelle

THE BIG PICTURE

CASH STASH How much guarantees a worry-free future? Here's what wealthy individuals and they would need:

WORTH LIVING COMFORTABLY
IN DOLLARS

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PNC Advisors, survey of 792 people
November, 2004

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fee is
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FAMILY MATTERS CONSULTING EVEN BEYOND THE GRAVE?

CALL IT THE PERK that keeps on giving. **Amalgamated Bank**, which owns 89,000 shares of **Tyson Foods**, alleges in a lawsuit filed on Feb. 16 that Tyson has contracts with four members of the Tyson family "and their cronies" that guarantee them consulting fees after they retire—and even after they die.

One former director, Robert Peterson, was entitled to \$400,000 a year plus other perks—payments that went to his estate after he died in May, 2004, according to the suit. Don Tyson, the son of the company's founder, gets \$800,000 a year. That's for up to 20 hours of work per month, even though he never earned more than \$600,000 a year as chairman and CEO. When he dies, the suit says, the payments will go to his survivors. "It is difficult to conceive what consulting services a deceased individual might provide to Tyson," deadpans the suit. Don Tyson's consulting deal runs through

2011. The suit didn't specify the length of Peterson's deal. The company declined comment, saying it had not been served with the suit. Don Tyson was unavailable for comment.

Amalgamated also alleges that Tyson Foods has done more than \$51 million in business with Tyson family members and directors from 2001 to 2003, including leases for farms, aircraft, and warehouses. At the same time, it

says, the board awarded options to executives and directors a few days before favorable announcements that would have pushed up the options' exercise price—in effect saving them \$5 million. Fortuitous timing? That's for a court to decide. —*Louis Lavelle*

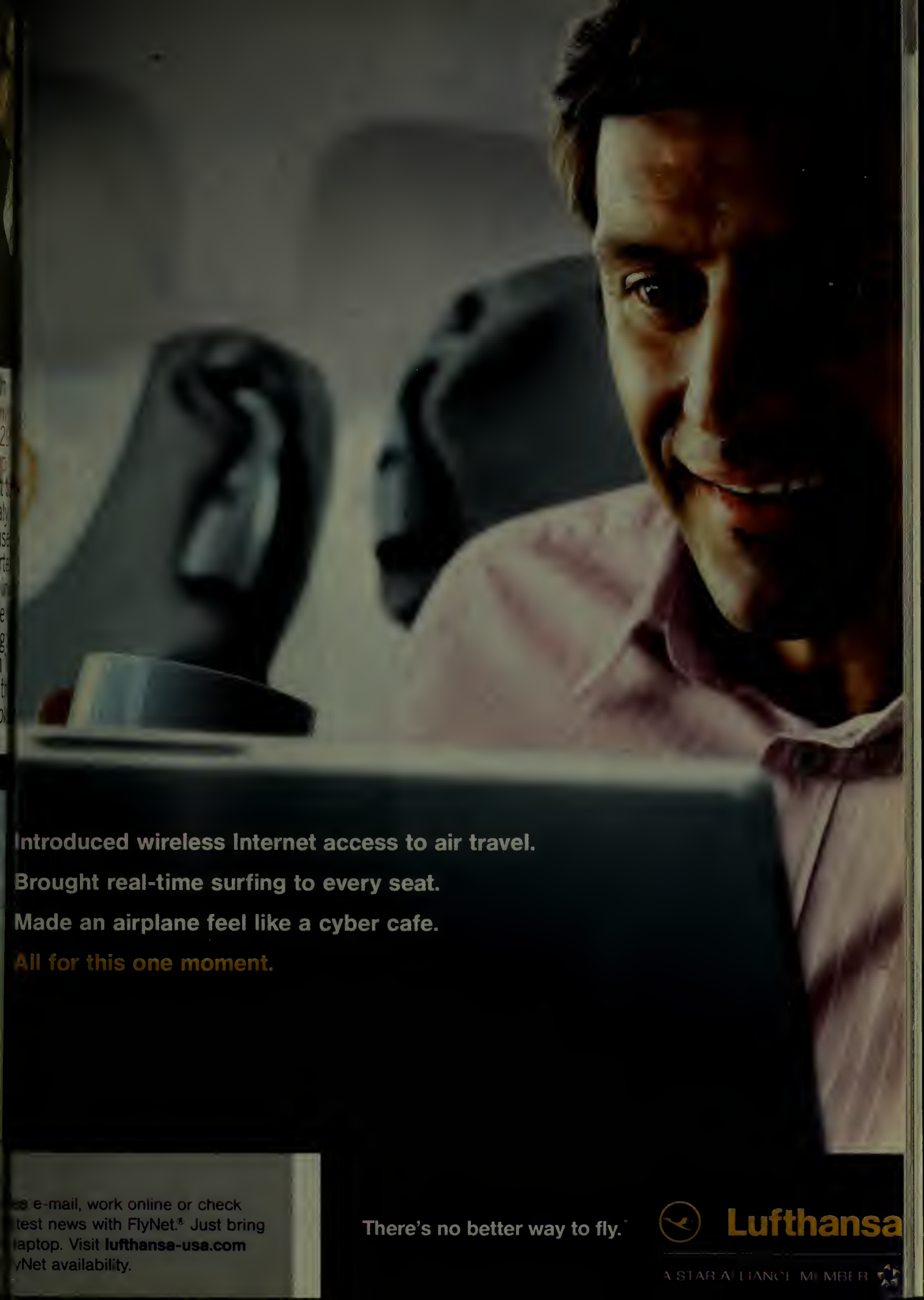
BOTTOMS UP AMERICA THE BIBULOUS

Can you hear the corks popping? By 2008 the U.S. will be, for the first time, the world's leading wine-drinking nation, says British researcher IWSR/GDR. Americans' growing taste for *vino* will push consumption up 29% to 730 million gallons a year, and sales up 44%, to \$24.2 billion, besting the current top three wine-drinking countries: France, Italy, Germany. While U.S. producers have cause for celebration, since they supply three-quarters of domestic consumption, this year's big gainers are from Australia. Brands from Down Under drove 64% of U.S. import growth in 2004, accounting for a third of import sales, up from a quarter in '03. France and Italy, meanwhile, spent '04 in the cellar, with 7% sales declines. —*Rachel Tipler*



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A STAR ALLIANCE MEMBER 

FACE TIME

BEN MANGAN



A SAVINGS PLAN WITH HEART

Ben Mangan's plan to combat poverty starts with savings. The key is an investment vehicle called the individual development account (IDA), open only to those making less than twice the federal poverty level, or \$37,000 for a family of four. Like 401(k)s, IDAs offer contribution matches, which come from donations and local and federal governments. Matchers get tax breaks, since contributions are considered charity.

The ex-consultant, who grew up in public housing, in 1999 co-founded San Francisco nonprofit Earned Assets Resource Network (EARN)—now the largest manager of IDAs, with 600. It offers a 2-for-1 match up to \$2,000 so earners can save \$6,000. IDAs—which can be used only for education, housing, or business—are scarce, but Mangan, 34, hopes to “[take] our ideas across the nation.”

On Feb. 9, EARN held a conference on policies that might promote IDAs in California. With good bipartisan back, Mangan's next stop is Washington. —Jessi Hempel

FAT CITY

A CALORIE-CONSCIOUS SPONGEBOB

IT HAS BEEN a tough month for SpongeBob SquarePants. He has been accused by a conservative group, **Focus on the Family**, of promoting a “gay agenda” and by the **Center for Science in the Public Interest** for contributing to child obesity by hawking **Kellogg's Pop-Tarts**, **Kraft Macaroni & Cheese**, **Oscar Mayer Lunchables**, and **Burger King**. Don't look for SpongeBob to stop holding hands with his friend Patrick, but he is working on shaping up a fitness image, starting with nutrition and fitness pitches on Kraft mac and cheese and Nabisco Fruit Snacks.

It's part of SpongeBob owner **Nickelodeon's** effort to get on the right side of the obesity debate. Thus, it has persuaded Kraft to add “Nicktritional” labels. For more than a year the No. 1



kids cable network has been adding TV and Web content featuring SpongeBob, Dora the Explorer, and Blue from Blues Clues to push physical activity and better eating. Nick spokesman David Bittler says the company has persuaded some advertisers that license its characters to plan switches to more healthful ingredients.

But weaning SpongeBob's \$1 billion-plus licensing

empire off its junk-food diet is “hard to do,” says Bittler. Many deals will take years to unwind, and some pact makers of healthful products are precluded for competitive reasons. As contracts expire, will Spongely stop pitching foods crammed with sugar, fat, artificial cheese, high fructose corn syrup, and the like? “It's all very much under review,” says Bittler. Stay tuned. —David K

WIRED LIFE

THIS PHONE SENSES YOUR EVERY MOVE

VODAFONE IS hoping that a gizmo-packed cell phone can lift its ailing Japanese arm. The \$200 handset, built by **Sharp**, has a special motion sensor developed jointly by the British carrier and Japan's **Aichi Steel**.

The sensor lets users control many of the phone's functions—such as navigating menus or playing games—essentially

by waving the phone in the air. Users can play a **Taito** golf game by swinging the phone as if teeing off onto a fairway or jiggle the handset to hear maracas or tambourine sounds.

Vodafone Japan—whose market share has been falling—needs a few birdies. On Feb. 7 its president of just two months, Shiro Tsuda, said he would step aside in April. But the new handsets use older, 2G technology, unlike higher-margin, 3G mobiles. And analysts think the appeal may be limited to young people or gadget nerds. —Ian Rowley



THE STAT

1

The rank of Splenda—soon to be in a version of Diet Coke—among sugar substitutes. The yellow-packeted sweetener surpassed Equal in 2004 in the \$350 million market.

Data: R.I. McNeil Nutritional

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Readers Report

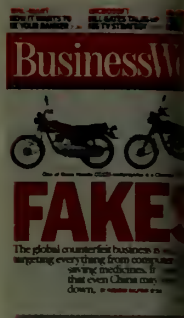
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Fakes are not all bad. Look at the PC industry. Without IBM PC clones, PCs would cost a lot more than \$550."

—Subrata Goswami
 Fremont, Calif.



A SHARPER FOCUS ON FAKERY

YOUR EXCELLENT cover story "Fakes!" (Feb. 7) fails to distinguish between "counterfeits" (illegal) and "knockoffs" (legal). For decades the apparel industry has regarded appropriation and reinvention as an essential part of creative progress. One reason that fashion has become a robust, competitive global industry is precisely because no one can "own" the creative design; the same principle accounts for the success of Linux and open-source software.

Passing off your work under someone else's name is consumer fraud. But drawing upon and transforming other people's creativity and presenting it under one's own name, has been around at least since Shakespeare "stole" from Ovid. Isaac Newton stood "on the shoulders of giants." Elvis "copied" the blues. Shut down creative emulation, and you shut down progress.

—David Bollier
 Amherst, Mass.
 —Laurie Racine
 New York

Editor's Note: The writers, senior fellows at the University of Southern California's

Annenberg School for Communication are co-founders of Public Knowledge, a public advocacy group for intellectual property and technology policy.

THE PROLIFERATION of private goods on the shelves of retail around the globe is not far removed from the parasitic nature of illegal counterfeiting and is much less difficult to address. These goods' success depends on the retailer's ability to manipulate subconscious shopping behavior with price offerings that copy the appearance of leading brands without the same level of quality or performance.

—David P. ...
 Cincinnati

FAKES ARE NOT all bad. Look at the PC industry. Without the IBM PC clones, PCs would cost a lot more than \$550. Without fakes are allowed to grow legitimately, bring down price and expand markets.

—Subrata Goswami
 Fremont, Calif.

FAKES MAY BE A CONCERN if they compromise safety, durability, fitness, or other real differences between the knockoffs and

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Readers Report

CORRECTIONS & CLARIFICATIONS

In our review of *The Guggenheims: A Family History* by Irwin Unger and Debi Unger, the family's core property should have been ASARCO, not ARASCO ("Up from stove black," Books, Feb. 21).

"This hedge fund can boogie" (Finance, Feb. 21) about JDS Capital Management Inc. reported that Daniel C. Stein once ran an Internet wedding-gift registry that he later sold to Martha Stewart Living Omnimedia Inc. In fact, the sale took place after Stein left the company.

"The reeducation of Oxford" (International Business, Feb. 14), should have listed Stanford University's endowment at \$10 billion, not \$13 billion. Yale University's endowment is \$13 billion.

real McCoy. But to use Louis Vuitton and Rolex as examples of the problem is exceedingly far-fetched. The Vuitton handbag fake, which is one-seventeenth the cost of the real thing, "wears out faster"—that's a reason for concern? Come on. Anyone who markets a product whose price is based mostly on exclusivity and not intrinsic value will always face this problem.

—Norman A. Abend
Wayland, Mass.

THE NATIONAL Association of Manufacturers calls on China and other foreign nations that harbor or tacitly enable criminal counterfeiters to get serious about prosecution and prison. Nations that export counterfeits must interdict far more goods in port. Companies need to provide more thorough data to customs services to make such interdiction more frequent on the incoming end. Companies also need to get smarter about detecting and shutting down domestic supply-channel abuses. And Congress must toughen U.S. criminal law. Only a broad-based, globally coordinated attack can reverse the growth in fakes.

—David Peyton
National Association of Manufacturers
Washington

THIS IS A WILD card, but if you can't beat 'em, join 'em: Bring counterfeiters on board. Corporations can solicit help from fake producers in identifying the means, mechanism, and manufacturers of counterfeit goods and provide the producers with strong incentives for joining the team.

—Abhishek Gupta
Cincinnati

ANNUITIES DESERVE THE HYPE

TAX-DEFERRED TREATMENT of earnings turbocharges savings in the phase of the annuity contract ("Don't believe the hype," Personal Business, 7). At the second phase, typically retirement, the annuity's accumulated value can be used in a way no other financial product allows—to provide lifetime income. Moreover, no other asset-management strategy can guarantee more retirement income over a long period. In an annuity, a point well documented by independent research by Jeffrey Brown of the University of Illinois.

—Frank Keating,
American Council of Life Insurance
Washington

Editor's Note: The writer is the former governor of Oklahoma.

A WAL-MART BANK? IT COULD HAPPEN SOON

I WAS AMAZED that "Your new bank" (News: Analysis & Commentary, Feb. 14) overlooked the fact that the Walton Family, the majority shareholders and founders of Wal-Mart Stores Inc., already own a bank. The bank, Arvest, has been slowly growing in the Oklahoma and Arkansas markets for the past several years and is run by one of Sam Walton's sons.

You were right when you quoted Bain & Co. analyst as saying it was a matter of when. When they do get past the legal hurdle, they will already have knowledge and depth of management to turn their banking ambitions into one of the largest financial institutions, basically overnight, with the experience and expertise that they have honed running Arvest.

—Luke Sontag
Tulsa

How to reach BusinessWeek

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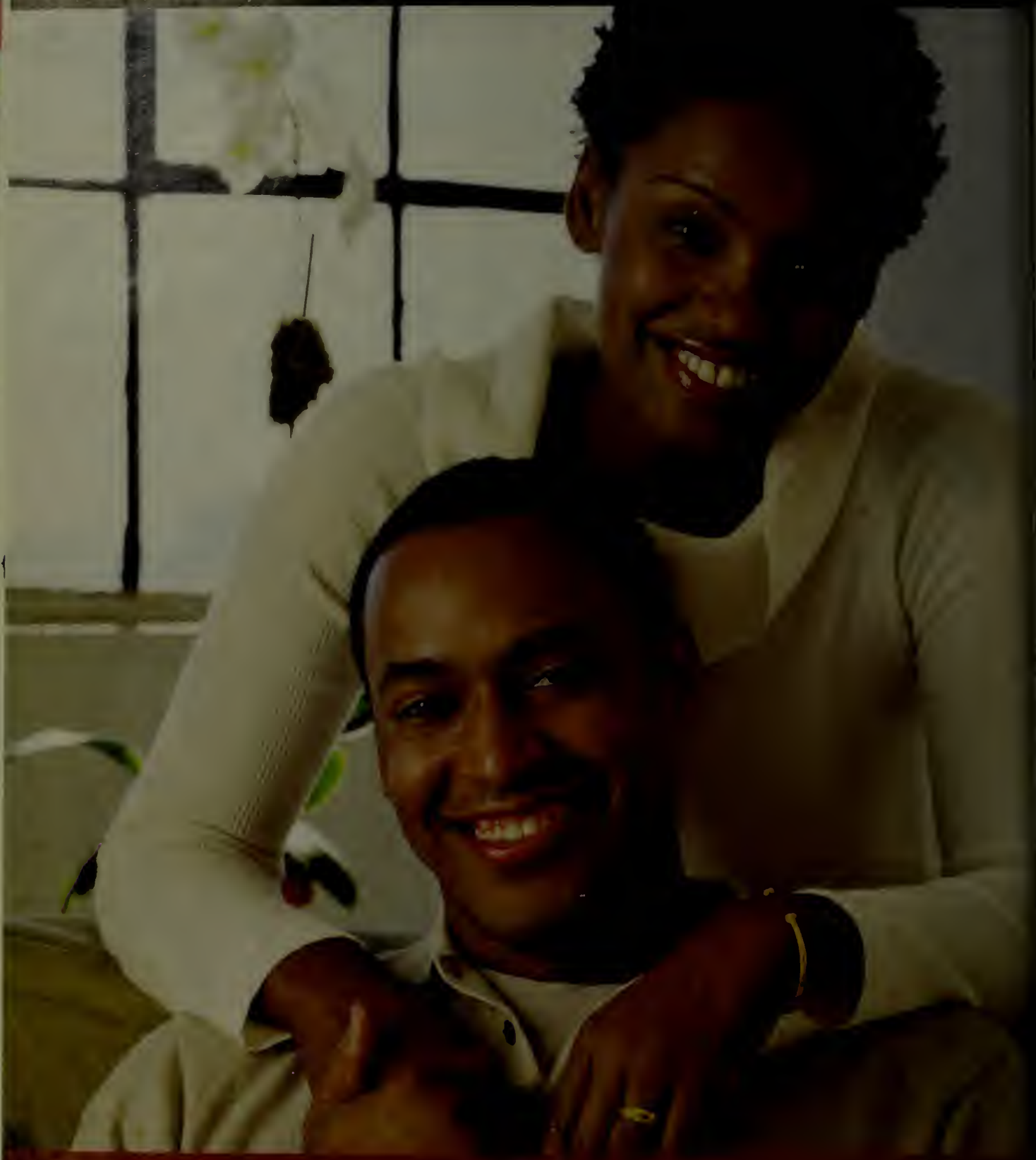
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TO GET TO
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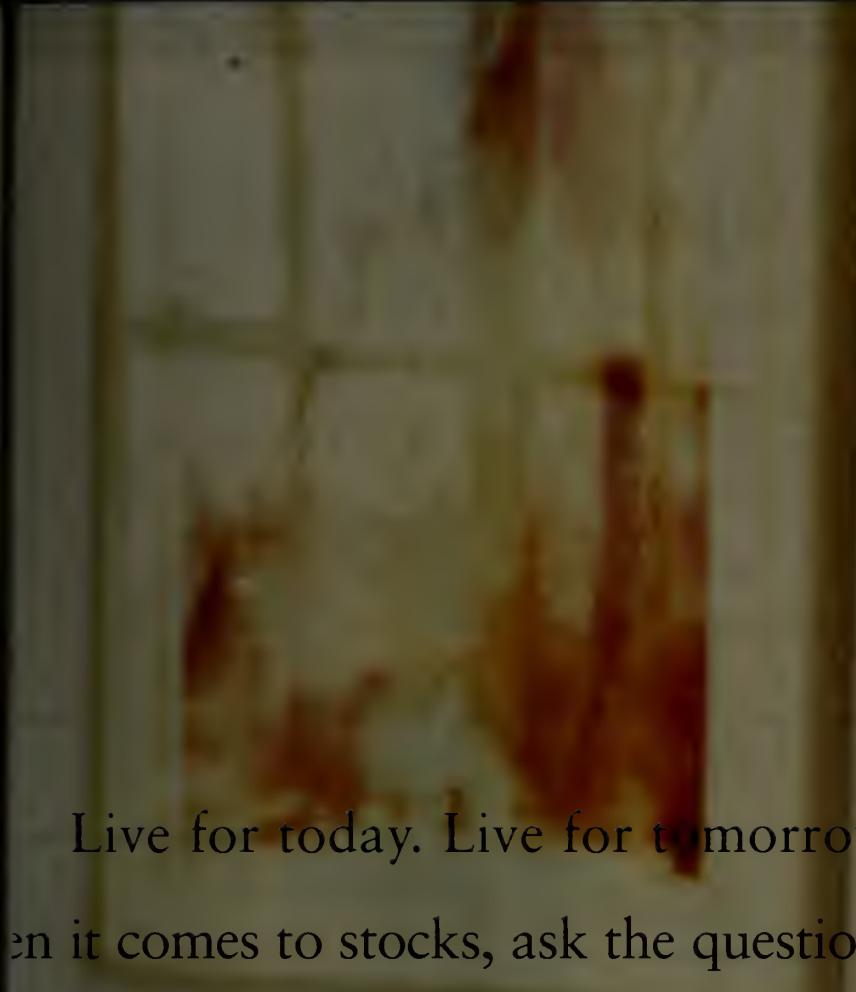
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Books

Emperor Eisner

DISNEYWAR

By James B. Stewart; Simon & Schuster; 572pp; \$29.95

The showdown in the Walt Disney Co. boardroom was quick and decisive. It was early 2003, as tensions were mounting over languishing earnings and top executive failures. But Michael D. Eisner was on the offensive, intent on taking out Andrea Van de Kamp, a board

member who was increasingly asking tough questions or siding with Stanley P. Gold, Eisner's harshest board critic. "You are a terrible director," Eisner scolded Van de Kamp in his office. "You're so loyal to Stanley. It's like you've carried his babies."

Staggered by the attack and the news that the nominating committee had purged her, Van de Kamp, a high-powered Los Angeles fund-raiser and head of auction house Sotheby's West Coast office, tried valiantly at a board meeting two days later to get reinstated. Arguing that she was being banished for exercising independence, she ticked off some of the low points of Eisner's tenure, including lavish exit packages to departing Disney executives, ABC's continued ratings funk, and the company's "terrible relations with Hollywood creative people because of Eisner's arrogance." But Eisner kept control of the board, and Van de Kamp was a goner.

Eisner's victory was short-lived, and soon Disney's board was hit with open revolt. Roy E. Disney and Stanley Gold, who had brought Eisner into the company in 1984, resigned and led the uprising that in 2004 prompted 45% of Disney shareholders to vote against Eisner. What remained of the Eisner myth had vanished. The man who had saved Disney from corporate raiders in 1984 had gone from prince to ogre—an imperial CEO driven by vanity and insecurity to expel those who questioned him. Indeed, the man who became a corporate hero by reviving the company that Walt Disney built soon felt he was

larger than the company itself—ruling by fiat, pitting rivals against each other, destroying ties with longtime friends and associates, and putting himself above even Disney shareholders and its board.

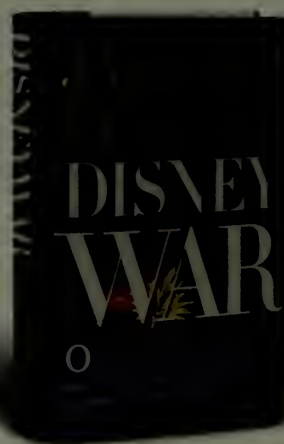
Such are the images in James B. Stewart's *DisneyWar*, an impressively researched, sometimes riveting if overly detailed account of Eisner's rise and

fall. It's also a story of the near destruction of an American institution. The book draws upon mountains of leaked documents from Disney's high-profile lawsuits involving former executives Jeffrey Katzenberg and

Vanity, fear, and loathing in Disney's Magic Kingdom

Michael Ovitz. Stewart, a Pulitzer Prize winner, got an inexplicably high level of access to a CEO under the heaviest pressure of his career.

So armed, the author chronicles Eisner's moves, misstep by misstep. Suspicious of underlings who achieve too much or won public attention, Eisner is shown as installing spies in offices of key lieutenants and even secretly collecting e-mails to keep track of those he didn't trust. At various points, Stewart writes, Eisner threatened to fire longtime partner Frank Wells, even plotting to replace him with stud chief Jeffrey Katzenberg while at the same time asking superagent Michael Ovitz to help him force out Katzenberg.



...ding to Stewart, Katzenberg's key
...was bringing Disney's animation
...back from near death, then
...ing too much press credit for it.
...ong the way, Stewart suggests,
...r's hubris harmed the company. Out
...que, he refused to negotiate the
...s of Katzenberg's severance deal—
...partly as a result, the settlement
...oned from \$60 million to \$280
...on. He overruled his theme park staff
...uilt a European park outside Paris,
...ge part because of his college
...nation with France, writes Stewart.
...ing attendance and French public
...ance to anything Disney have
...led the park ever since, nearly
...ng it into bankruptcy at one point.
...er thwarted efforts by Miramax co-
...der Harvey Weinstein to buy potential
...ains such as Bravo! and Independent
...Channel from Cablevision Systems
...., then wildly overpaid for the ABC

Family Channel. His largest mistake:
buying ABC, which saddled the company
with losses and years of internal manage-
ment turmoil. Meanwhile, Eisner's golden
gut was tarnished: The company turned
away such hits as *The Apprentice*, *CSI*,
Crime Scene Investigation, and *Survivor*.

For all of its copious detail, Stewart's
book raises as many questions as it
answers. How will the negative publicity
affect the chances of Robert Iger—the
only internal candidate—to succeed
Eisner, who has said he will retire in late
2006? ("He can never succeed me,"
Stewart quotes Eisner as saying.) And
what about Eisner? He tells Stewart the
board "might come to me" with an offer
of the chairmanship. Stewart's charges
of Eisner's mismanagement won't help
the CEO stick around. Of course, in
Hollywood, nothing ever ends until the
curtain comes down. ■

—By Ronald Grover

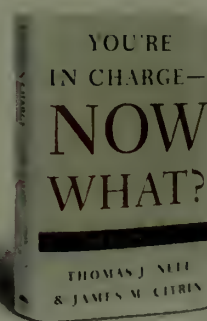
Brief

ight Isn't Enough

RE IN CHARGE—NOW WHAT?
8 Point Plan

Thomas J. Neff and James M. Citrin;
In Business; 299pp; \$25

...ear most authors of
...ness books tell it, there is
...management conundrum so
...t that it can't be solved by
...left application of seven or
...t basic principles. The
...h-nors are almost always
...ng: Big public companies
...too many moving parts to
...form to any set of simple
...cepts. Thomas J. Neff and
...es M. Citrin, noted headhunters at
...pal search firm Spencer Stuart &
...ociates, know this well. Yet their
...k, *You're in Charge—Now What?*,
...s into the trap. It presents an eight-
...nt plan for executives to succeed in
...r first 100 days in a new job. The
...ame is a thorough but ultimately
...mulaic treatment of a subject handled
...veral previous books.
...Neff and Citrin base their account on
...udy of more than 100 leadership
...cessions that have taken place in the
...t five years. They have interviewed
...ens of chief executives, including
...neral Electric's Jeffrey R. Immelt,
...s W. James McNerney, and Gap's



Paul S. Pressler. The overwhelming
majority of examples involve chief
executives who made all the right moves
in their first 100 days and went on to
guide their companies to great success.
Such experiences can be instructive—
but certain tales of failure might carry
even more valuable lessons.

As confidants of some of the nation's
most prominent CEOs, Neff and
Citrin are in a choice position to
offer advice, and there's plenty
of it here. In particular, their
suggestion to go slowly—in
developing a team and
transforming the corporate
culture—is on target.
Unfortunately, much of the rest
of the advice is either obvious,
too generic to be useful, or at
odds with guidance offered a

few pages earlier. For example, they
have equal admiration for CEOs who
give board members free rein to make
unchaperoned plant visits and those
who keep boards in the dark. Both can't
be right.

You're in Charge will no doubt be a
comfort to many new-to-the-job CEOs.
Its vignettes of executives grappling
with difficult problems will help others
confront their own quandaries. But the
book makes success seem simpler than
it is—and it doesn't begin to get at what
makes the best managers exceptional.
As those CEOs well know, there's no
eight-point plan for that.

—By Louis Lavelle

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BY STEPHEN H. WILDSTROM

Drowning in Remotes? Thank Cable Operators

As home entertainment systems grow more complex, it makes increasing sense to have something in charge of the octopus of players, displays, and video and audio sources. Today, to watch a movie, I have to find the remote that goes with my display and see which of its seven inputs is connected to the DVD player. I'd rather just click "play DVD" on a menu.

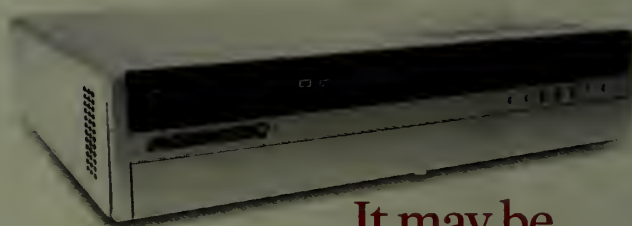
This simple idea is difficult to implement when PCs are part of the mix, and a major reason is the difficulty of integrating cable television into the system. A device called a CableCARD, which is supposed to eliminate the need for a cable set-top box, could be a huge help. But CableCARDS aren't easy to find, they don't work with Microsoft's Media Center PC software, and, the way things stand now, they don't completely replace the box.

The cable box performs two different services: It decodes the digital cable signal into a format your TV can display. And it tells the cable system what channels you are authorized to view, a function called conditional access. Your PC can actually take care of the decoding. So can a TiVo box or any number of other electronic devices. But if you decide to go this route—managing your TV through something other than a cable box—you'll need the credit-card-size CableCARD to provide the conditional access.

Federal Communications Commission rules require cable services to rent CableCARDS to anyone who wants one, typically for about \$2 a month. Unfortunately, the companies don't go out of their way to promote the cards. (Search Comcast's Web site, and you won't even find a mention of them.) The industry is battling an FCC requirement that would force them to provide CableCARDS for all set-top boxes, including TiVos and PCs, by July, 2006. That would free consumers from the need to rent boxes.

MY EXPERIENCES TESTING an Alienware DHS 2 computer, based on Media Center software, show why a CableCARD is so badly needed. The DHS 2, which starts at \$1,579, is a black box that looks more like a stereo receiver than the PC it is. It has all the features of Windows XP, and it provides just the sort of centralized control I am looking for—or it would, if my cable system would cooperate.

Alas, to get a TV signal from my Comcast digital cable box to the DHS 2, or to a video recorder, I must use an additional



**DHS 2: MEDIA CENTERS
AREN'T GREAT FOR TV**

**It may be
too soon
to replace
your cable
set-top
box**

device called an IR blaster. And even then, the cable box won't transmit high-definition TV signals. The upshot is, I can use the Alienware PC to play CDs, watch digital videos, or play digital music, but for TV, the cable system has to bypass it and connect directly to the television.

Microsoft will eventually offer a more useful version of the Media Center that can take a CableCARD. And TiVo plans a CableCARD-based video recorder. These products may be premature—nice as it would be to get rid of the set-top box. The current CableCARDS are badly crippled because they don't give you access to the usual program

guide provided by your cable company. You also lose the ability to order pay-per-view programs and watch movies and other shows on demand. A new generation of CableCARDS that enables these services is planned, but the new cards won't work in current CableCARD-ready gear.

One alternative to a CableCARD is a set-top box that can supply digital video to a recorder or other component. FCC rules require cable companies to supply such boxes, but the regulation is not being enforced. And there is a chance that such systems might eventually be rendered obsolete by changes in copy-protection technology.

I hope the FCC not only sticks to its guns on CableCARD regulations but also pushes cable operators to move beyond grudging acceptance and make the cards truly useful. Meanwhile, I'll grumpily stick with my set-top box and the multiple remotes of a system that at least works. ■

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ESCAPE

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BY ROBERT J. BARRO

The Case of Asia's 'Missing Women'

In 1990 my Harvard colleague Amartya Sen caused a stir by observing in *The New York Review of Books* that excess female mortality in China, India and other Asian countries meant that there were 100 million women few in the world than there should be. The presumption was that the excess mortality came from discrimination against women by men and govern-

ments. Although the estimate was lowered to 60 million by demographer Ansley Coale's more detailed analysis in the 1991 *Population & Development Review*, this still shockingly large number became a symbol of discrimination against women in developing countries. Many people think the reason is abortion and the killing of newborn girls. But new research suggests another reason. Harvard economist Emily Oster, in her PhD thesis "Hepatitis B and the Case of the Missing Women," suggests that biology explains a good deal of the missing-women puzzle.

In Western countries, such as the U.S., the ratio of male to female births is around 1.05. Higher male mortality leads to decreasing male-female sex ratios as the population segment gets older. In the whole population, the two forces roughly cancel each other out, leading to an overall male-female ratio close to 1. In contrast, since at least 1980, male-female ratios are around 1.08 in China, India, and Pakistan. This demographic phenomenon is limited to Asia and does not relate to economic development. The male-female ratios are not high in sub-Saharan Africa and Latin America.

The Sen-Coale assumption was that the high ratios in Asia reflected high female mortality rates. They calculated how many women would have existed if female mortality rates had been normal, which Coale computed in relation to a country's overall life expectancy. The difference between this hypothetical number of women and the actual number equaled the missing women.

Oster argues that this calculation overlooked something crucial—unusually high male-female birth ratios in Asia years before abortion became widespread. Given mortality rates by gender, a rise in the male-female birth ratio leads to an increase in the male-female population ratio. Motivated by Baruch Blumberg's book, *Hepatitis B: The Hunt for a Killer Virus*, Oster sees the high incidence of the hepatitis B virus (HBV) as a major culprit.

There is much evidence that parents infected by HBV are more likely to have male children. Places with substantial HBV—Asia, Alaska, and parts of the former Soviet Union—tend to have high male-female birth ratios. Studies in Greece and France show that HBV-positive parents had male-female ratios for offsprings of 1.7 to 1.8, vs. 1.1 to 1.2 for those

who are HBV-negative. This pattern also shows up among migrants, with those from high HBV areas, such as China, having high male-female offspring ratios in the U.S.

The biological explanation for the HBV effect is unclear, though it may involve more frequent spontaneous abortion of female fetuses. But the effect is large, concentrated in certain regions, and susceptible to elimination via the HBV vaccine. In Alaska, the use of the HBV vaccine in 1982 led to a sharp decline in high male-female birth ratios.

Among Asian countries, the HBV influence is greatest in China, explaining 75% of Coale's missing women. In India the adjustment is less important, explaining only 17%. For Asian countries in general, Oster locates 46% of the absent women, ending up with 33 million missing, rather than Coale's 60 million or Sen's 107 million.

The culprit may not be government policy, but hepatitis B virus

Looking ahead, broader use of the HBV vaccine should lower male-female ratios. But another force—sex-selective abortion—which wasn't critical before the 1980s, is growing in importance because of the spread of ultrasound technology and, in China, the one-child policy. In Chinese censuses the male-female birth ratio rose from 1.09 in '82 to 1.13 in '89 and

1.18 in 2000. The 1982 ratio likely reflected HBV prevalence but the subsequent increases probably reflected sex-selective abortion. An obvious countermeasure: Eliminate the one-child policy.

The Oster research features interactions between biology and family behavior and government policy in the sensitive area of gender studies. This is the kind of research that Harvard President Larry Summers recently advocated in widely criticized remarks. Fortunately, the typical approach in economics is to take on almost any topic that can be usefully tackled with economic tools and let the data speak for themselves. ■

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JAMES C. COOPER & KATHLEEN MADIGAN

Time to Cope with Co-Dependency

U.S. trade deficit demands a reckoning—but progress will be slow

U.S. ECONOMY After years of being ignored, the U.S. trade problem reached its Willy Loman moment: Attention must be paid. Finally, economists and government officials are debating the dangers of a \$618 billion-and-growing annual trade deficit to the U.S. economy and what to be done to narrow it. The fix won't be easy because the hurdles

are high. More important, Americans' appetite for exports and dislike for savings has created a "global co-dependency." As a result, the U.S. trade deficit has become an international puzzle because foreign exporters depend heavily on U.S. markets and U.S. growth depends heavily on foreign capital. Bear in mind that these global imbalances didn't develop overnight. In 1992, the U.S. trade deficit for goods and services totaled \$39.1 billion for the whole year. For December, 2004 alone, the gap was \$56.4 billion. After adjusting for prices, the growing trade gap subtracted 0.5 percentage points from economic growth last year. The current account, the sum of all foreign transactions including income on assets, was roughly in balance in 1992. In 2004, the current account deficit was 1.1% of about 5.5% of gross domestic product. It will likely go above 6% in 2005.

The magnitude of these numbers argues that any progress will be slow in coming. And unless the trade deficit is contained, at least as a share of GDP, the growing imbalance will further increase the risks of a runaway dollar that could generate severe ripple effects throughout the global financial markets.

FEDERAL RESERVE CHAIRMAN Alan Greenspan touched on this and other subjects when he gave his annual testimony on monetary policy to Congress on Feb. 16. The Fed chief sounded hopeful that the dollar's decline since early 2002 would soon foster the effects that will limit foreign imports and boost exports.

Earlier, in a Feb. 4 speech devoted solely to trade, the chief ran through the reasons for the widening deficit. First, due partly to the dollar's previous strength, the level of imports is about 50% higher than exports. So, he noted, "exports must grow half again as quickly as imports just to keep the trade deficit from widening—a benchmark that has yet to be met." Indeed, the latest data show that over the year ended in December, exports rose 11.2% while imports grew 16.8%. Yearly export gains have consistently lagged behind import gains during this business cycle.

The three-year fall in the dollar is expected to quicken

the pace of exports this year. But the shortfall between export and import growth probably won't narrow much because of another reason cited by Greenspan: "The growth of the U.S. economy has exceeded that of our trading partners." And overall economic growth is a big determinant of a country's appetite for imports. But for instance, in the fourth quarter, the U.S. grew at a 3.1%

annual rate, while Japan, Germany, and Italy all recently reported their economies shrank.

For 2005, the U.S. seems poised to outpace the global economy once again. In conjunction with Greenspan's congressional testimony, the Fed released its central tendency forecasts for economic growth and inflation

THE FED: GOOD GROWTH AND LOW INFLATION

FED'S CENTRAL TENDENCY FORECAST (4Q TO 4Q PERCENT CHANGE)

	2005	2006
REAL GDP	3.75-4.0	3.5
CORE INFLATION*	1.5-1.75	1.5-1.75
UNEMPLOYMENT RATE (4Q AVG.)	5.25	5.0-5.25

*PCE PRICE INDEX EXCLUDING ENERGY AND FOOD
Data: Federal Reserve Board

(table). Policymakers expect U.S. real GDP to grow 3.75% to 4% in 2005. By comparison, private economists see world growth at just over 3%.

AND EVEN IF, BY SOME CHANCE, the global economy were to match the growth of the U.S. economy, it would not narrow the trade deficit. As Greenspan said: "The responsiveness of U.S. imports to U.S. income exceeds the responsiveness of U.S. exports to foreign income."

That differential is not new. This economic behavior, known as the Houthakker-Magee income effect, was first noticed back in the 1960s. However, the U.S. propensity to buy imports has been growing over time. According to economists at Société Générale, for each extra dollar spent today on consumer goods, excluding autos, 45¢ goes to imports. That share is up from 25¢ in 1997 and just 15¢ in 1990. The problem, as Greenspan said, is that even if the U.S. and foreign economies grow at about the same rate, U.S. imports will still grow faster than American exports will.

You would think the dollar's slide would curb Americans' appetites for imports. But that has not been

the case so far. Although the dollar has plunged 15.4% in the past three years, nonoil import prices have increased only 6% (chart). Greenspan noted that foreign producers are willing to swallow most of the cost of a cheaper dollar rather than accept a drop in their U.S. sales.

AFTER ALL, the world's trade deficits and surpluses must all add up to zero. So if the U.S. reduces its gap, other countries must experience a shrinkage in their trade surpluses or a rise in their deficits. As Catherine L. Mann, a senior fellow at the Institute for International Economics, points out, foreign countries depend on U.S. imports both directly and indirectly for economic growth. This dependency is most apparent in Asia, but it is a trend around the world. And it argues that a shrinking dollar alone is inadequate to narrow the deficit.

In a speech last year, Mann laid out the mutual benefits and risks in what she calls "the global co-dependency" of the U.S. trade deficit. Overall, "countries have a vested interest in a large and chronic U.S. trade deficit. Their dependency on U.S. demand as a source of growth matches the U.S. dependency on foreign savings to finance domestic investment."

The Treasury's December report on international capital flows shows the U.S. continuing to benefit greatly from foreign savings. Foreign purchases of long-term securities ended 2004 on a strong note, with foreign buying averaging some \$790 billion, at an annual rate. That's about \$100 billion greater than the funds needed to finance the quarter's current account deficit. Asian

policymakers especially are amassing U.S. government securities and working to stop the dollar's depreciation against their respective currencies in order to keep their products competitively priced for the U.S. consumer.

The risk is that the dollar will continue to slide, causing foreign-held U.S. assets to lose value. Says Mann, "These policymakers trading off the positive certain benefits of export-led growth today against the negative certain capital loss on their holdings of U.S. assets tomorrow."

For the U.S., Mann says co-dependency is the benefit of providing relatively cheap financing and expanding buying power that creates

demand for imports. At the same time, as foreign governments defend their currencies, the actions have limited the dollar's depreciation and hampered U.S. export growth. Little wonder the trade gap keeps rising.

Clearly, a combination of solutions will be needed to narrow the deficit. Further dollar depreciation will help, especially vs. the Chinese yuan. And the U.S. needs to increase its domestic savings. But whatever the mix of remedies, the trade gap has taken center stage, and don't expect it to go back into the shadows anytime soon. ■

THE DOLLAR'S MUTED IMPACT ON PRICES



JAPAN

Quick, Start the Business Rally

WILL THE BUSINESS SECTOR save the Japanese recovery? That's the question after the economy shrank unexpectedly in the fourth quarter.

Real gross domestic product fell at an annual rate of 0.5% last quarter, the third decline in output in a row. A drop in consumer demand and a worsening in net exports caused the decline. But weather very likely held down the spending figures. Japan was hit by three major tropical storms from October to December, and temperatures were unseasonably warm at yearend, holding back demand for winter items.

Economists expect household spending to rebound in the first quarter, especially since the job markets are improving. The

ratio of jobs to applicants rose to .94 in December, from .77 a year earlier. And December's unemployment rate was 4.4%, down from 4.9% at the end of 2003.

However, the real key to generating momentum lies with the business sector. The one bright spot in the GDP report was a 2.8% annual rate gain in capital investment. And new orders for machinery were up strongly last quarter, suggesting spending will keep rising in 2005.

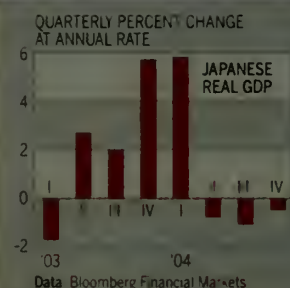
Business can fuel growth, as well as keep the job markets improving, because companies are sitting on lots of cash. According to Ministry of Finance data, operating profits rose at an annual rate of 54% in the second

quarter of 2004 and a further 26% the third. In addition, the latest Tankan report showed that enterprises were more upbeat in the fourth quarter compared to the third on their readings for sales and profits.

As has happened before, revision could wipe out the GDP drop. But it doesn't mean the outlook is free and clear. First, the expected pickup in 2005 exports—which account for 11% of GDP—depends on a rebound in overall global growth. But the latest bad economic news from the euro zone, as well as the yen's continued strength against the U.S. dollar, raises questions about such optimism. Second, the Bank of Japan has begun to signal a possible early start to tighter monetary policy. So while news of the recovery's death may be premature, the Japanese economy still faces some risks to growth. ■

—With Ian Rowley in Tokyo

THE ECONOMY STUMBLES AGAIN





WHAT DID YOUR CONSULTANTS LEAVE BEHIND?

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ATKEARNEY IDEAS THAT LAST.

HEDGE FUNDS

THE NEW RAIDERS

They're back—but with a twist.
The latest wave is led by hedge funds
flush with billions in cash

BOSTON HEDGE FUND Highfields Capital Management apparently had had enough. It watched in dismay as its investment in the nation's No. 3 electronics retailer, Circuit City Stores Inc., floundered. Finally it took action. But Highfields didn't sell its 6.7% stake and then maybe try its luck at shorting the stock. Instead, it decided to buy the whole company, making a surprise \$3.25 billion bid on Feb. 15. The stock soared 16% that day.

Highfields and its reclusive managers, Jonathon Jacobson and Richard Grubman, are on the leading edge of a new wave of corporate raiders. Flush with hundreds of billions of dollars in cash from investors and hard-pressed to maintain the double-digit returns they promise as competition stiffens, many hedge funds are reinventing

themselves as private investment firms. They charge the high fees of a hedge fund but, no longer content with shorting shares or pursuing other hedging strategies, they're seizing control of companies.

BUTTING HEADS

IN ALL, HEDGE funds and their affiliates have announced deals for at least 23 companies, valued at about \$30 billion, in the past year. Already, New York-based Cerberus Capital Management, named for the three-headed dog that guards the gates of hell in classical mythology, controls companies worth at least \$20 billion that employ tens of thousands of people.

The escalating battle over chunks of Corporate America is creating fear and outrage in many executive suites. Even if they're unable to buy companies outright, hedge funds are winning board seats, ousting chief executives, and forc-

ing companies to shape up by making big stock and bond purchases. The butting heads with rival buyers for outposts that are for sale and launching hostile tender offers for those that aren't, they're no respecters of size. A former Morgan Stanley managing director, Stephen Sippelle, the 42-year-old chairman of billion Copper Arch Capital, has been so frustrated at his old firm's underperforming stock that he is publicly calling on the company with a \$65 billion market cap to dump its credit-card and retail brokerage operations. Morgan Stanley insiders believe he is trying to put his company in play.

Some of the raids threaten to be far bloodier than those launched a generation ago by Street-smart raiders such

DEJA VU

Our cover image from the Mar. 4, 1985, issue

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landscape

38 Early dividends are
prominent in deals

40 In search of the
perfect interest rate

46 For a CEO to last,
adaptability matters



as T. Boone Pickens and Henry R. Kravis. For one, the new raiders don't need any help financing their deals, as the 1980s crowd did. A few have \$10 billion or more in their war chests. Dozens have more than \$1 billion, a far cry from the select group that dominated the takeover game back then.

What's more, the new raiders can be more aggressive than their predecessors because the times allow them to be. In the wake of Enron and other scandals, companies have never been as vulnerable to shareholder demands as now. Businesses must disclose more information than ever, their poison pills are gone, and their spats with shareholders on earnings calls are widely broadcast. Hedge funds can exploit this changed climate because, unlike traditional buyout funds, they don't have conservative pension funds that loathe the public controversy stopping them from making hostile moves.

It's not just CEOs who are suffering sleepless nights. Traditional buyout firms are getting the jitters, too. Some, such as Texas Pacific Group, are setting up partnerships with hedge funds to compete for investor dollars. Some bankers expect that, as more hedge funds turn hostile, the more nurturing private-equity firms will present themselves as white knights ready to ride to the rescue of the hedgers' targets. "I would not be surprised if private-equity firms tried to top Highfields' bid for Circuit City," says Alan K. Jones, a senior banker at Morgan Stanley.

Still, hedge funds are rewriting the rules for Corporate America. They are supplying jet fuel for mergers and acquisitions. And their leaders are emerging as a new managing class. Some are forcing managers to admit that assets, such as real estate, are worth more than entire businesses. They are taking the idea that CEOs work for shareholders to an entirely new level, speeding up the revolving door to head honchos' offices. "We're not going to see the Jack Welch any more who are allowed their periods of ups and downs," says John Challenger, CEO of executive recruiting firm Challenger, Gray & Christmas Inc.

Private equity firms charge that these

SWASHBUCKLER, INNOVATOR, ALCHEMIST Hudson, Lampert, and Shaw (clockwise from top left)

often young, impatient numbers guys who run hedge funds and sit for hours in front of computer screens are ill-equipped to run companies. Veteran buyout specialist Kravis warns that hedge funds do not know how to create value. "Companies are not pieces of paper," echoes Michael G. Psaros, founding partner of private equity firm KPS Special Situations Funds.

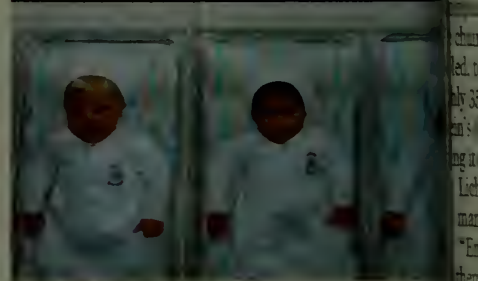
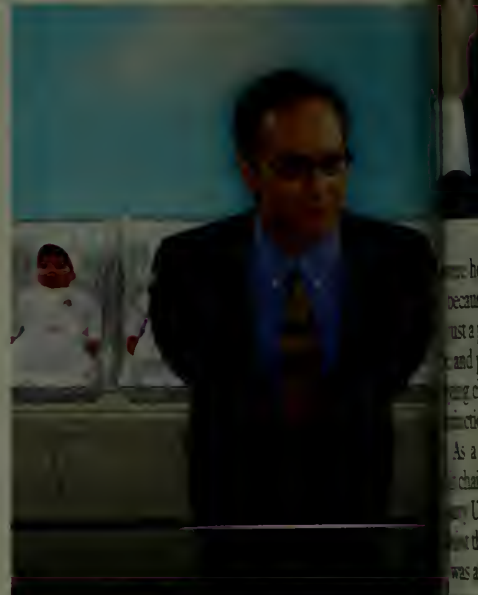
Hedgers maintain that they are better qualified to run businesses than are most chief executives. "I've invested in hundreds of companies," brags 39-year-old Thomas R. Hudson Jr., founder of nearly three-year-old Pirate Capital, which has raised almost \$400 million and had a 29% return after fees last year. "Most CEOs have come up through the ranks. Maybe they've worked at four or five places." Plus, some hedge funds have former CEOs and CFOs on their payrolls, ready to be parachuted in at a moment's notice.

The new raiders often hunt in packs. In August, several, including Och-Ziff Capital Management Group, teamed up with Berkshire Hathaway and White Mountains Insurance Group to buy insurer Symetra Financial, formerly owned by Safeco, for \$1.35 billion.

Some funds buy just enough stock to bark out orders to management. Call them the Attack Dogs. Others, the Midas Men, straighten out struggling companies. Then there are the Crackerjacks, who use cutting-edge maneuvers to outsmart other bidders. Here's how they work:

THE ATTACK DOGS

WHEN 39-YEAR-OLD Warren G. Lichtenstein made a hostile bid for rocket-motor-maker GenCorp Inc. in November, he



stunned Wall Street vets who never imagined a hedge fund buying such a company. But for Lichtenstein, founder and principal of the \$3 billion New York-based Steel Partners, it was all in a day's work. From his perspective, he "owns" companies, bought with downpayment of less than 15% of their stock—as thou

The Whole Enchilada

Hedge funds are increasingly buying companies, not just blocks of shares

TARGET	Sears	LNR Property	Circuit City	MeadWestvaco	Me
BUYER	ESL Investments/ Kmart	Cerberus Capital Management**	Highfields Capital	Cerberus Capital Management***	Cerberus Manag
PRICE (BILLIONS)	\$13	\$3.8	\$3.2	\$2.3	\$1.4
DATE*	Nov. 17, 2004	Aug. 29, 2004	Feb. 15, 2005	Jan. 18, 2005	July 2

Data: *Forbes* Financial Markets

*Date of deal or offer announced



Tough Breed

Hedge funds taking control of companies today are a very different breed from 1980s raiders

»They are numerous and **LOADED WITH CASH**. Rarely loners, they hunt in packs and use **AGGRESSIVE TACTICS** such as ousting managers and targeting underperforming companies.

»They employ **SOPHISTICATED STRATEGIES**, such as simultaneously holding shares in both target companies and acquirers. And they're prepared to **BUILD CONGLOMERATES** while companies rush to shed businesses to focus on their core strengths.

ere houses. "We're called a hedge because of our fee structure, but just a partnership that can invest in public and private companies. We hedge for a long time, not for a short time, and it's cheap," he says.

inction without a difference? Perhaps. As a major shareholder, Lichtenstein is chairman of aerospace technology company United Industrial Corp. There's a hint that just two years ago Lichtenstein was an outsider waging war against the company's management. Since he became chairman, the company's stock has risen, to \$33. That contributed to the 35% return after fees that Lichtenstein's fund racked up in the past year, making it one of the hottest around. What Lichtenstein bring to companies managers can't? "Discipline," he says. "Empower the people. And then hold them accountable."

Now Lichtenstein is setting his sights on bigger trophies. He used to invest in small million companies. These days he is mostly for bargains in the \$2 billion range, believing he'll fare better because there's less risk in bigger companies. They employ higher-quality people who ultimately have more suitors willing to pay top dollar for them, yet they are riddled with inefficiencies and excessive costs.

Another top raider prefers a more swashbuckling image. Surrounded by buccaneer memorabilia in Pirate Capital's office in Norwalk, Conn., Hudson and his crew fire off lawsuits and testy letters to

companies that they consider poorly run. They helped to oust the chairman and CEO of educational services provider Cornell Cos. and to attract offers for John Q. Hammons Hotels Inc.

James A. Mitarotonda, a co-founder and principal of Barington Capital Group, has created waves, too. From his office opposite Carnegie Hall in New York City, he spurred changes that led to the Feb. 7 resignation of the CEO of Register.com Inc.

THE MIDAS MEN

AT THE OTHER END of the spectrum, most deals pursued by Midas men are not hostile. But these alchemists who spin distressed companies into gold increasingly find themselves facing off against private equity and corporate buyers for bargains. Stephen A. Feinberg, founder of Cerberus, which manages more than \$14 billion, backed out of a deal last year for Clayton Homes Inc. that was also pursued by Warren E. Buffett.

But Feinberg has outmaneuvered other buyers to pick up old-line companies such as Anchor Glass Container and MeadWestvaco's paper unit along with its 900,000 acres of forest land. In December he took public BlueLinx Holdings Inc., a building-products distributor bought from Georgia-Pacific Corp. last May.

Iconic companies aren't out of the hedge funds' reach. D.E. Shaw & Co., with \$12 billion in capital and populated by PhDs, bought toy emporium FAO Schwarz out of bankruptcy last year. Founder David E. Shaw, himself a PhD in computer science, personally promised Frederick August Otto (F.A.O.) Schwarz,

Jr., the founder's great-grandson, to make the retailer the world's greatest toy store. "Our feeling was that the brand was strong and the things FAO used to do were important and worth something," says Shaw, whose mother viewed toys as works of art. "If we brought [FAO] back to its original mission, [the company] should be profitable."

If Shaw pulls off the revival, it will indicate that hedge funds can be better managers than critics give them credit for. There are positive signs. People beg to be let in to FAO Schwarz's flagship New York store on Fifth Avenue before its doors open at 10 a.m. Once it's time, three salespeople, dressed as toy soldiers, roll out a red carpet and blast a trumpet to greet shoppers. Shaw says the catalog and online businesses have "exceeded expectations." The company says it is profitable.

THE CRACKERJACKS

HEDGE FUNDS ARE adept at finding new wrinkles in traditional dealmaking. Like many financiers, Edward Lampert's ESL Investments started buying shares of his target, Sears, before making a bid for the company. But there was a twist: He already owned and ran the company's rival, Kmart Corp., and it was Kmart that actually made the bid.

Consider, too, Richard Perry's battle with Carl Icahn, the legendary financier. Icahn—who is trying to raise about \$3 billion to start his own hedge fund—is suing Perry Capital for \$1 billion for allegedly meddling in a proposed acquisition of generic-drug producer King Pharmaceuticals by a larger rival, Mylan Laboratories. Icahn charges that Perry used complex hedging techniques to obtain shareholder voting rights without holding an economic interest in the shares. Perry declines to comment.

The reinvention of hedge funds marks a new era for the industry—and for Wall Street. During the 1990s fund managers took their cue from George Soros, morphing into multistrategy types and taking advantage of inefficiencies between the world's stock, bond, and currency markets. In a similar metamorphosis, hedge funds now are buying whole companies.

Some of the new raiders simply want to make changes, rake in the rewards, and move on. Others plan to hold on to companies and rebuild them over the long haul. Either way, they're not long on tolerance. If CEOs slip up, these guys will take their companies from them. Consider yourself warned. ■

—By Emily Thornton, with Susan Zegel
in New York

M&A

THE SHIFTING TELECOM LANDSCAPE

With AT&T and MCI going, the Bells will compete with cable and tech companies

IN THE SPAN OF TWO QUICK weeks, longtime telecom icons AT&T and MCI have toppled from the corporate scene. First, SBC Communications Inc. announced on Jan. 31 that it would buy AT&T for \$16 billion. Then, on Feb 14, Verizon Communications said it would snap up MCI for \$6.7 billion, persuading MCI's board to reject a higher bid from Qwest Communications International.

The swallowing of the stalwarts of long distance by their Bell rivals marks a historic shift as a long and bruising battle in telecom draws to a close. Since the 1996 Telecommunications Act, long-distance giants have been duking it out with Baby Bells over the residential phone market. Now the Bells have vanquished both Ma Bell—their former corporate parent—and former upstart MCI Inc.

But as that era fades, another is dawning. "This is the end of World War I—the Bells vs. AT&T and MCI," says Scott C. Cleland, a telecom analyst at Precursor Group in Washington. "Now, World War II, among the phone, cable, and tech companies, is about to begin."

Indeed, should the SBC-AT&T and Verizon-MCI takeovers go forward, they will be just the beginning of a massive transformation sweeping the telecom industry as the shift to digital technology gains speed. That's rapidly eroding the barriers between phone companies, cable providers, and other tech companies. The Bells are moving from the residential phone market they've dominated into a new set of digital ventures in wireless, data, video, and corporate services. Phone calls delivered over wires are becoming a commodity service that is under assault from wireless calling, e-mail, and Internet phoning over cable operators' wires. So the Bells have little choice but to seek fresh markets.

Verizon and SBC have already announced ambitious plans to offer TV service over superfast fiber networks in residential neighborhoods. Now the purchases of AT&T and MCI help them accelerate selling phone and data services to corporations—beyond their traditional consumer market. Selling to corporations, which are less likely to change providers than fickle consumers, is seen as a source of potential growth and a hedge against the high-stakes play for residential video and other services via fiber. As Verizon CEO Ivan G. Seidenberg told Wall Street analysts on Feb. 14: "If we don't change, we'll be caught repricing old products."

REWRITING THE RULE BOOK

THE PHONE GIANTS' efforts to break down the barriers among the voice, data, and video industries come at an opportune time for Washington policymakers. Outgoing Federal Communications Commission Chairman Michael K. Powell set the stage for the latest mergers by undercut-

ting rules that would have helped AT&T and MCI challenge the Bells in local phone markets. Now, whoever succeeds Powell must tussle with the issues raised by the evolving competitive landscape. Meanwhile, new Senate Commerce Committee Chairman Ted Stevens (R-Alaska) plans to start a rewrite of the 1996 Telecom Act. "These deals represent a change in 20 years of market structure," says former FCC Chairman Reed E. Hundt. Policymakers "will have to scratch their heads hard." But the Bush Administration isn't likely to block the mergers over antitrust or competitive concerns. And the large corporate customers being targeted by the new behemoths have the clout to negotiate favorable prices for themselves.

For the two super Bells, AT&T and MCI offer a fresh corporate customer base and a leg up for some of their consumer businesses. One example: The long-distance carriers' extensive Web backbones can speed the Bells' deployment of Internet TV. "By using AT&T's network, SBC can offer TV more rapidly," says AT&T CEO David W. Dorman. Perhaps more important, corporations are a largely untapped market for the B consumer-oriented wireless business offices adopt wireless phoning—a many see happening soon—Verizon SBC can sell phones that double as mobile handsets for employees on the road

Goodbye, Long Distance

	REVENUE, IN BILLIONS						COMPOUND ANNUAL GROWTH RATE
	2003	2004	2005	2006	2007	2008	
Video	\$0.2	\$0.3	\$0.5	\$1.0	\$1.6	\$2.5	65.7%
Consumer broadband	2.8	3.5	4.0	4.2	4.6	4.8	11.4
Consumer long distance	20.7	18.2	16.0	13.6	11.3	9.2	-15.0
Business local	26.3	26.7	26.4	26.1	25.8	25.5	-0.6
Business long distance	26.1	24.5	23.0	21.3	19.7	18.2	-7.0
Business data*	44.8	45.6	46.6	47.1	46.8	45.4	0.3
Consumer local	46.9	42.2	39.0	36.2	34.0	32.3	-7.25
Wireless	91.5	108.7	119.2	132.8	144.5	153.6	10.9
Total	\$260.7	\$271.5	\$277.0	\$285.0	\$291.3	\$294.9	2.5%

*Includes Internet access, private data lines, ATM traffic, and frame relay

Data: Stat-MDR



competition, regulators can't rest easy. The recurring problem for policymakers is the lack of competition for the last-mile connection to homes. There the Bells and cable companies still typically are the only relatively affordable options consumers have for broadband connections. Chances are the two rivals will "settle into a cozy duopoly" to avoid price wars, says former FCC Chairman William E. Kennard, now a managing director at Carlyle Group, a private equity firm in Washington. Policymakers' best hope for more price competition may come from startups such as wireless mogul Craig O. McCaw's ClearWire Corp., which sells broadband at affordable rates in select markets via WiMax wireless technology.

TRAFFIC JAM

COMPETITION IN residential broadband will become even more vital as the telecoms and cable operators plan to sell more services on top of that basic fast Web link. Both want to move up the food chain to reap more revenues per subscriber, potentially putting them in conflict with others that need access to the same broadband pipes. Vonage Holdings Corp., for instance, is selling voice-over-Internet phone service over cable just as cable operators are entering that business, too. Regulators will need to provide safeguards so the phone and cable giants that control the broadband networks don't discriminate against service providers that they compete with.

The takeovers of AT&T and MCI officially usher in the long-heralded Internet era. The old phone compa-

nies are artifacts, and the new telecoms will look more like their counterparts in cable and computers. As players realign themselves during this upheaval, Washington will need to remain on the lookout for signs of monopoly power. But for the most part, consumers and companies will increasingly have their pick of new services from a bunch of providers that are fighting hard to win their business. ■

—By Catherine Yang in Washington, with Brian Grow in Atlanta, Steven Rosenbush in New York, and Roger O. Crockett in Chicago

Regulators must ensure all players have access to broadband networks

voice-over-Internet phones that workers at their desks can use over office Wi-Fi networks. "You're going to see business and consumer overlap," says MCI Chief Executive Michael D. Capellas. Yet in each of their new endeavors, both Verizon and SBC will face experienced rivals with a big head start. The enterprise market is already teeming with the likes of AT&T, Electronic Data Systems, Accenture, and other systems integrators. While these longtime corporate consultants may not have the Bells' wireless capabilities, they know how to sell corporate software applications over the Web—a fast-growing and highly profitable business that both Verizon and AT&T are trying to crack. In the consumer market cable behemoths such as Comcast Cable and Time Warner Cable are already delivering the bundles of voice, data, and video services telecoms want to enter. "We have spent the past three years preparing for a major rollout of Internet protocol phone service, and that doesn't change by what other companies do," says Comcast Cable COO Stephen B. Burke. Clearly, the Bells have plenty of catch-

ing up to do. They're still building the fiber networks over which their TV services will run and lack the programming expertise that is part of cable execs' DNA. Verizon, which spent \$1 billion to serve 1 million homes last year, plans to cover an additional 2 million homes this year. And SBC is spending \$5 billion to reach 18 million homes in major markets within its 13-state territory by 2007. But compare that to the cable industry, which already has the ability to deliver TV, broadband, and phone service to 99 million households. Indeed, some smart money is getting behind cable. Over the past six months, Warren Buffett's Berkshire Hathaway Inc. has doubled its stake in Comcast, to 10 million shares, now valued at \$328 million. And late last year, George Soros made an initial investment of \$51 million in Time Warner, according to government filings.

While the phone giants will face stiff

FINANCE

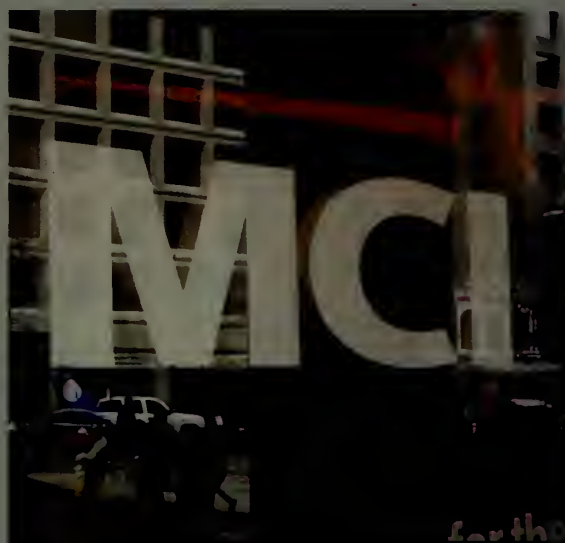
Will Dividends Drive A Slew of New Deals?

How do you make a \$6.7 billion deal look like a \$5.3 billion bargain? The investment bankers working on Verizon Communications Inc.'s purchase of MCI Inc. apparently think they've found a way. And if they pull it off, they'll likely encourage a string of copycats—all of whom will owe a note of thanks to President George W. Bush for pushing through the 2003 tax cut on dividend income.

To understand why, start on Feb. 14, when Verizon and MCI execs announced their deal. While MCI shareholders would get \$6.7 billion if they agree to the sale, Verizon said the purchase would cost its shareholders only \$5.3 billion. To make up the difference, MCI agreed to pay its shareholders the extra \$1.4 billion, or \$4.50 a share, in dividends. The money would come out of MCI's own cash before Verizon ponies up its \$5.3 billion and actually takes over. Adding to the fog over the true value of the deal: a second slug of cash, \$488 million, would be part of Verizon's

payment; moreover, MCI shareholders were already scheduled to receive 40¢ of that suddenly plumper dividend. "We are offering...a total package of about \$6.7 billion. But it is \$4.8 billion of Verizon equity, and the rest of it is in a variety of cash distributions that come from MCI's cash board," said Verizon Chairman and CEO Ivan G. Seidenberg in a conference call held with MCI Chief Executive Michael D. Capellas on the morning of the deal.

Some major MCI shareholders are complaining bitterly, particularly now that details of the much richer bid by Qwest Communications International Inc. have been made public. Excluding the special dividend, Verizon is offering MCI investors \$16.25 a share in stock and cash, while Qwest's offer, which



GRUMBLING Dissidents see "a slick use of words"

does not include an extra dividend, totals \$23 a share in stock and cash. "It is a slick use of words," says Bruce R. Berkowitz, CEO of Fairholme Capital Management LLC, which holds about 3.5% of MCI stock.

THE STAT

**\$1.4
BILLION**

The amount in dividends MCI shareholders would receive before Verizon ponies up \$5.3 billion of the \$6.7 billion deal.

Data: Company reports

Berkowitz says the cash payouts amount to nothing more than handing back to MCI shareholders their own money. He is talking with two other major shareholders, Leon G. Cooperman of Omega Advisors Inc. and John Paulson of Paulson Investment Co., about what, if anything, they can do to get a higher price from Verizon. Together they own roughly 10%. Berkowitz says he's eager to know where MCI's kingpin shareholder, Mexican magnate Carlos Slim Helú, who owns a 13.8% stake, stands. Slim could not be reached for comment.

Capellas began meeting with Berkowitz and other shareholders on Feb. 15 to make his case. He argued, according to a spokesman, that if Verizon were not taking over MCI, the company would not be able to

turn over so much cash. The plan is to call for a vote on the deal in May and pay the dividends shortly afterward. Verizon spokesman Peter Thonis says the offer "is very good deal for MCI shareholders."

With those dividends as an incentive—and the promise of quick payment—execs and their bankers hope to appease dissidents and boost the odds of getting the deal approved. Indeed, without the early payment, MCI investors would have to wait until the deal clears federal and state regulators before they'd see an penny. That could take as long as a year.

Another aspect of the deal's structure could be enticing. The dividend would be taxed at only 15%, less than half the short-term capital-gains tax rate that investors would pay on profits from stock bought within 12 months, says Robert Willens, a tax and accounting expert at Lehman Brothers Inc. Verizon's Thonis says the deal wasn't structured specifically to get the tax advantage. Still, it makes things juicier for short-term holders.

The fallout could go far beyond Verizon and MCI. The 2003 dividend tax cut clearly makes such a pre-close dividend more valuable since that 15% rate is the same as the one that applies to long-term capital gains. As a result, many short-term takeovers speculators could save on taxes by taking profits in pre-close dividends. "Now this will probably be a staple of pretty much every merger," predicts Willens. In fact, the Verizon-MCI deal resembles a smaller pre-close dividend that was tucked into SBC Communications Inc.'s bid for AT&T just two weeks earlier. As part of that deal, AT&T announced it would pay a \$1.30 per share special dividend just prior to the deal's closing. That's a slower payout and amounts to only about 7% of the \$16 billion that AT&T shareholders will get in the SBC deal; by comparison, the MCI dividend represents 21% of the \$6.7 billion payment to investors.

When deals are structured to save taxes, sellers won't demand as much money from buyers for their companies. If, in turn, buyers find they can do deals by paying less, they'll likely do more deals. How many more is speculation. But even one is probably one more than Congress or the President imagined when they changed the tax law.

—By David Henry in New York, with Brian Grow in Atlanta

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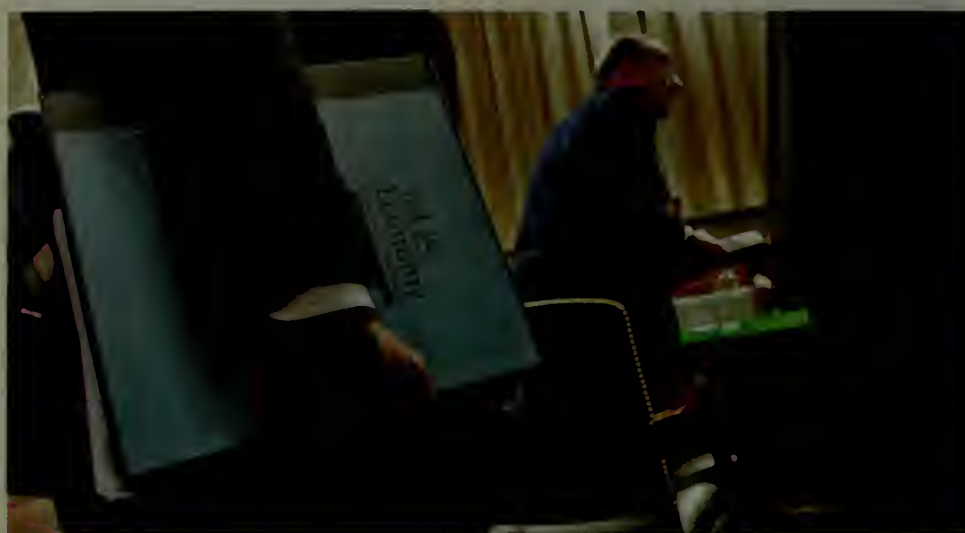
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THE ECONOMY

THE FED'S MAGICAL MYSTERY NUMBER

What's the interest rate that perfectly calibrates the economy?



WHEN FEDERAL RESERVE Chairman Alan Greenspan and central bankers began raising interest rates last June, the decision to go ahead was a no-brainer. After all, at 1%, the federal funds rate was well below what economists call the equilibrium interest rate, which perfectly calibrates the economy, neither spurring inflation nor dampening growth. But after seven months of steadily raising rates, the Fed is finally being forced to confront the question of where that magical level lies.

The problem, as Greenspan told the Senate Banking Committee on Feb. 15, is that "we don't know what the actual rate is." Historically the inflation-adjusted fed funds rate has averaged about 2.5%, suggesting that's as good a

starting point as any in trying to determine equilibrium. At the current 1.5% inflation rate, the neutral, or equilibrium, fed funds rate should come out at roughly 4%. But mindful of all the uncertainties in the economy, Fed officials currently reckon the zone of neutrality is anywhere from 3% to 5%.

That's a huge range, leaving Fed officials pondering how much more they need to raise rates. Six bumps since June

have brought the funds rate up to 4.25%. No one at the Fed is suggesting that should stop there. Still, two distinct camps inside the central bank seem to be emerging: those who believe short-term rates need to go significantly higher to remove excess liquidity from the economy, and those who fear the consequences of pushing rates much higher, especially at the lower end of the range at 3%.

DRAGS ON GROWTH

THE FIRST—the "we've only just begun" group—consists mostly of regional bank presidents. They argue that higher rates are needed to keep the U.S. economy on an even keel as strong productivity growth stokes demand for capital. They fret that the Fed's easy monetary policy has led to speculative excesses in real estate and financial markets. The second group, the "we're almost done" camp—mostly Fed board members in Washington—is arguing for pushing short-term rates up much more. They insist low rates are needed to offset the drags on growth from high consumer debt and the big U.S. trade deficit. They see the current low yields in the bond market as a vindication of that view.

Where does Greenspan stand? He hasn't said, but the betting is that he is leaning toward the side with his fellow board members rather than the more hawkish regional Fed presidents. But

GREENSPAN
Is his policy too easy?

now Greenspan seems to be straddling both camps. In his Feb. 16 testimony to Congress, he said the Fed had raised rates "significantly" although they still remain "fairly low."

Both sides make compelling arguments. The hawkish group argues that strong productivity growth means the funds rate should climb to the top of the 3% to 5% neutral zone, above its long-term real average. Strong productivity growth, they argue, should induce businesses to invest more.

The rising demand for capital puts upward pressure on interest rates. If the Fed keeps rates low, it risks overheating the economy.

Indeed, there are signs that companies' spirits are stirring. Mergers and acquisition activity has taken off. Business borrowing is picking up. When, then, do the inflation hawks at the Fed make of the yields prevailing throughout the bond market, the Treasury and corporate

How High Should Rates Go?

Inside the Fed, two distinct camps are emerging:

WE'VE ONLY JUST BEGUN

- The Fed needs to push short-term rates much higher, to 4% or more from today's 2½%
- Higher rates are essential to avoid inflation and to keep demand for capital in balance
- Easy monetary policy has fostered excessive risk-taking in financial markets

WE'RE ALMOST DONE

- Fed tightening should soon end, with short-term rates peaking at 3% to 3½%
- Low rates will help offset the drag on growth from consumer debt and the big U.S. trade deficit
- Lackluster global business investment signals that the Fed should use caution raising rates



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curities to emerging-market debt and junk bonds? Perhaps, they say, it's a sign that monetary policy is still too easy. With short-term interest rates remaining low, investors have felt compelled to buy any asset where they think they can pick up some yield, be it junk bonds or emerging-market debt. What's more, some Fed officials fret, the central bank may have lulled investors into a false sense of security with its stated intention to keep hikes "measured." In a speech on Jan. 10, Atlanta Fed President Jack Guynn bemoaned the fact that some investors see that declaration as a stronger commitment than it actually is.

AWASH IN SAVINGS

THOSE AT THE FED who worry about going too far see things the opposite way. To them, the low bond yields worldwide mean that the Fed should be cautious about pushing short-term rates up too high. They contend that global bond markets indicate that the world is awash in savings. That's why most countries, with the exception of the U.S., are running current account surpluses. These nations, including Japan and Germany, lack adequate investment opportunities at home to put their money to work, leaving real yields low worldwide. Even with the big U.S. budget deficit, the inflation-adjusted yield on the Treasury's 10-year note is running at about 1.5%, well below its long-run average of closer to 3%.

The real 1.5% yield on 10-year notes is below the long run average

There are more reasons for the Fed to be slow to push short-term rates too far above 3%; say policymakers. Fed Vice-Chair Roger W. Ferguson Jr. suggested in a speech late last year that the Washington's drive to slash the \$412 billion budget deficit—if it succeeds—could check growth and thus inflation, an argument for relatively low interest rates. A move by debt-laden consumers to cut borrowing could have the same effect, although there's hardly a sign of that happening yet. So far, the Fed has had an easy time raising interest rates. Inflation has stayed low, growth has been steady, and the financial markets have remained calm. But now its task is getting trickier—and the debate inside the Fed over what comes next will only grow more pointed. ■

—By Rich Miller in Washington

BOND MARKET

Where Did All the Long Bonds Go?

Is there a worldwide shortage of long bonds? It may seem like an odd question to ask when a host of governments—from the U.S. to Britain to Japan—are running huge budget deficits. But it's one that the financial markets increasingly are debating.

And no wonder. Just look at what's happening to the prices of longer-dated government securities. In the U.S., the yield on the Treasury's 5½% bond coming due in February, 2031—the longest maturity available—has fallen about a half percentage point since last December, to 4.52%. In the process, the spread between the higher-yielding bond and the Treasury's key 10-year note has narrowed to just 37 basis points, about half of what it was a year ago. The trend extends beyond the U.S.: The British Treasury's 30-year bond is actually yielding less than its 10-year counterpart. That's highly unusual, since longer-dated securities normally carry higher yields to compensate investors for added risks.

Behind the sudden popularity of long bonds are changes, actual and prospective, in regulations governing pension funds aimed at shoring up their finances and protecting retiree benefits. Those modifications are prompting pension plans to step up their long bond purchases to more closely match the maturity of their assets to their longer-dated liabilities. The rule changes started in Britain two years ago, spread to the Netherlands, and now may be heading to the U.S.

On Jan. 10, the Bush Administration proposed a wide-ranging plan for reforming the way the \$1.8 trillion private-pension fund industry operates, including the elimination of a host of regulations that have allowed the funds to legally underestimate the size of their liabilities. If

approved by Congress, the reforms could prove to be a bonanza for the bond market. When the Bush Administration put forward similar proposals some two years ago, the Committee on Investment of Employee Benefit Assets surveyed its pension fund members to see how the proposed changes would affect them. The bottom line: As much as \$650 billion of pension fund assets could be shifted out of U.S.

equities into long-term bonds.

That has hedge fund and other speculators salivating. They have piled into long bonds, gambling that the controversial proposals will be enacted by Congress, which will then force the pension funds to enter the market in force. "There has been a lot of hot money trying to front-run pension plans on the notion they will be

forced to buy," says Paul McCulley, managing director at the giant bond-fund manager Pacific Investment Management Co. McCulley, however, thinks such speculation is overdone.

In response to the surge of interest in longer-dated securities, both Britain and France are studying the possibility of issuing 50-year bonds. The U.S. Treasury, in contrast, contends that it has no plans to begin reissuing 30-year bonds. In a move that stunned investors, Treasury stopped selling long bonds 3½ years ago when the government's finances were in better shape. At that time, it argued that the action would save taxpayers money. U.S. corporations have not been so shy. They have recently stepped up their issuance of 30-year securities, says John Lonski, chief economist at bond rating agency Moody's Investors Service. If the long bonds continue to be in short supply the Treasury may be forced to rethink its position and join in. New longer-dated debt may be long overdue.

—By Rich Miller in Washington
with Laura Cohn in London

IN DEMAND

A shortfall of long-term bonds sends yields tumbling



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AVIATION

BOEING CATCHES A TAILWIND

Since New Year's, the jetmaker has racked up orders for 138 new planes

FOR SOME TIME, BOEING CO. has been playing second fiddle to Airbus. The European jetmaker has outsold and outmarketed the U.S. aircraft company. Boeing botched two vital sales campaigns that it was expected to win last year—in Germany and Malaysia. And on Jan. 18, European leaders gushed over the rollout of the new Airbus crown jewel—the 555-seat A380, which will supplant Boeing's 747 as the world's largest commercial jet.

But don't write Boeing's obituary just yet. Since Jan. 1 the Chicago company has racked up orders for 138 new planes, compared with just 38 for its European rival. That includes 65 orders for its ballyhooed new 250-seat 787 Dreamliner. "When the dust settles, Boeing might be doing a lot better than people previously believed," says Michael Boyd, president of Boyd Aviation, an aviation consulting firm. "The momentum will shift to Boeing because it's about to ride on the wings of the 787."

Both Boeing and Airbus are benefiting from a recovery in the commercial-airplane market. Some of Boeing's sales actually had been notched last year, but the customers delayed unveiling the purchases until recently. And more an-

nouncements are on the way. That's why Boeing raised projected aircraft output on Feb. 2, forecasting deliveries will grow more than 17% in 2006, to 380 planes.

The two competitors have made different bets on the future. While Airbus trumpeted its big A380 jetliner to fly between congested hubs, Boeing is pegging its future on the market for smaller jets that fly long distances directly between two cities. Boeing figures the market for planes with 200 to 400 seats—the 787, 777, A330, and A340—at 5,200 units over 20 years. Analysts peg the market for planes with just 100 to 200 seats—the 737 and A320—at 14,000 over 20 years. Both companies agree that the majority of plane sales will be in these two categories. But they disagree on demand for the jumbos such as the 747 and A380, which have more than 400 seats. The A380 has notched 139 orders in four years. Airbus predicts a market of more than 1,200 jumbos, while Boeing forecasts sales of

MULALLY with the Dreamliner in Paris in 2003

only 800—with half in the A superjumbo class. Whatever ha

with the big jet 787 is already one of the fastest-s commercial planes ever. As of Fe about 15 airlines have placed 191 for the airliner, which consumes 15 fuel than the A330 and can fly nons Beijing from New York. Airbus hasn nounced any formal customer inter its new A350—an upgrade of the intended to compete with the 787.

EASTERN PROMISE

NOWHERE IS BOEING'S edge gr than in Asia. It has strong bonds in gion where relationships matter. Al though its planes sport higher st prices, their range and lower costs to ate and maintain give them an adva in this market. Boeing last year still trolled 53% of the Asian market for v body planes—those with 200 or 1 seats—according to Airclaims Ltd., a sulting firm. "Boeing has a fortress in and it's called widebodies," says Mo Stanley analyst Heidi Wood. Aware weakness, Airbus recently hired Gle Fukushima, a former U.S. trade negot with long experience dealing with Jap

That threat comes on top of an ex tive shakeout and the airline melda after September 11. But Boeing has come much more disciplined. It k three product lines and focused on 737, 777, and 787. Now it is consid upgrading the 747 to compete with A380. "It has been a quiet, confident, steadfast transformation of the pro line and the production system," s

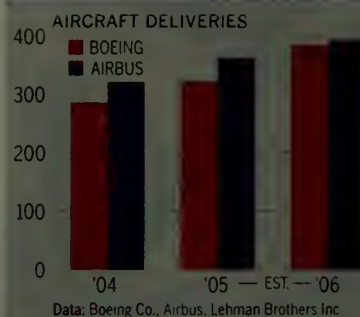
Alan R. Mulally, of the Boeing Co commercial Airpla unit in Seattle. that is producing sults. Boeing co mercial airplane p it margins will cli from 5.5% in 200 6.5% in 2006. R enue could grow \$28 billion, up fr \$24 billion in 200

Still, Airbus v probably outsell B

ing for the next six years because of continued strength in the small-jet m ket. And it will sell more of its me A380s. But with brisk sales of the 78 the air war between Boeing and Airbu again turning into a real dogfight. ■

—By Stanley Holmes in Sea

COMING ON STRONG

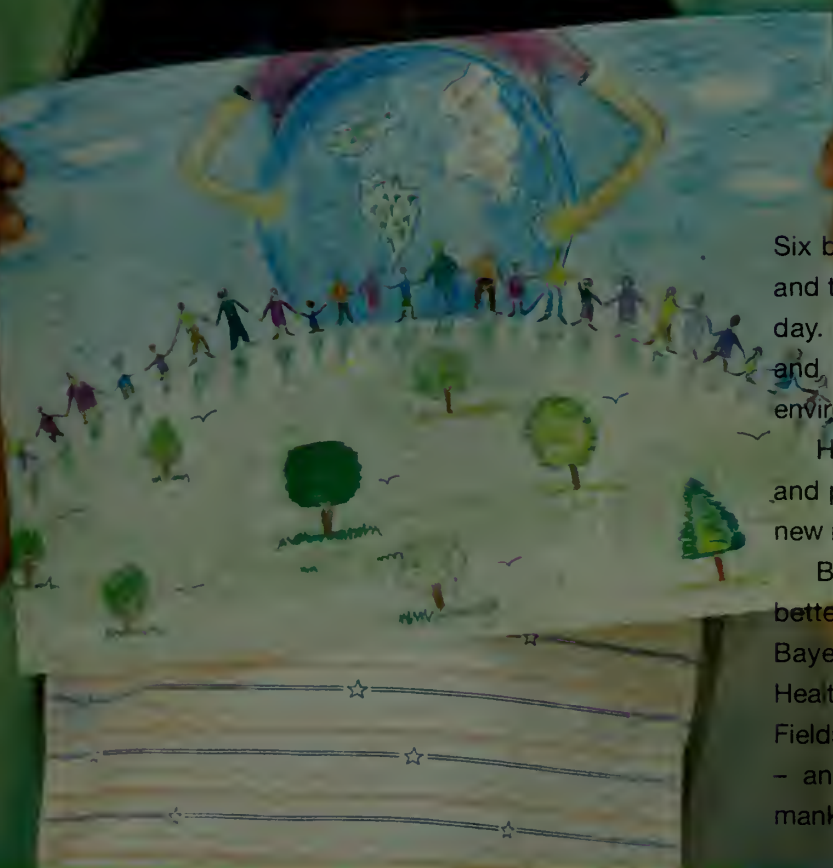


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COMMENTARY

BY LOUIS LAVELLE

Three Simple Rules Carly Ignored

Why things went wrong at HP—and went right at P&G, UTC, and IBM

CARLETON S. FIORINA faced a daunting task when she took over as CEO of Hewlett-Packard Co. in 1999. She was an outsider brought in to revive a troubled tech giant. Iconic though HP was, its deeply rooted engineering culture was badly in need of an overhaul. Her failure to achieve her goals was a fiasco that reflected the quirks of both Fiorina as an ex-

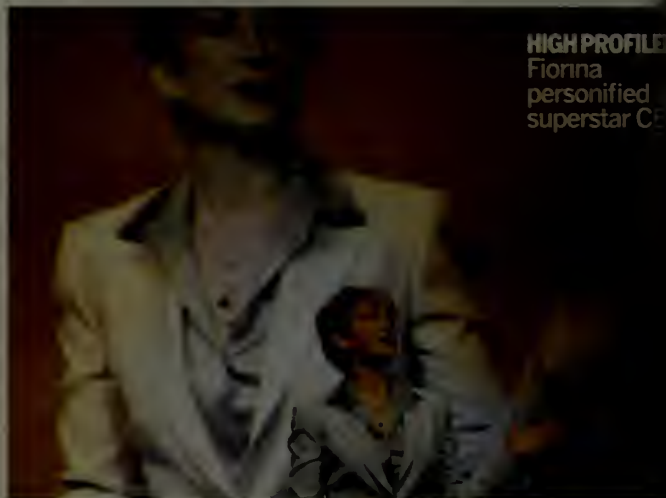
ecutive and HP's corporate milieu. So are there any lessons here about how to handle the job of shaking up a company or its business model? Certainly, it is difficult to generalize—every CEO has his or her own style, every company has its own culture. But Fiorina broke three key rules that most CEOs would do well to heed.

MAKE IT ABOUT THE COMPANY, NOT YOU. By the time CEOs rise to their post, most have a healthy ego, and Fiorina was no exception. She was also a sales whiz known for high-profile marketing events and a fondness for global gatherings packed with A-list politicians, celebs and CEOs. Problem is, many who spent time around her came away with the impression that she was as interested in burnishing her own image as she was in turning the company around. As Jim Collins noted in his 2001 book, *Good to Great: Why Some Companies Make the Leap...and Others Don't*, the defining hallmark of market-beating long-term leadership is the exact opposite—CEOs who place their companies' well-being above all else, including themselves.

Nowhere has that difference been starker than at Procter & Gamble Co., which has seen both kinds of leaders over the last decade. Durk I. Jager sought to shake up P&G's insular culture and jump-start innovation when he took over the helm in 1999, but his abrasive nature and insistence on rapid change alienated the troops. Under Alan G. "A.G." Lafley, who also has a broad agenda but a less contentious and more patient style, P&G has made a comeback. Lafley also has no qualms about letting others take credit for success—a critical trait for enlisting subordinates to your cause.

KNOW YOUR COMPANY INSIDE AND OUT. As skilled an executive as she was, Fiorina focused on marketing and didn't fully

Fiorina didn't have a strong No. 2 to offset her weaknesses



HIGH PROFILE
Fiorina personified superstar CEO

ly comprehend the impact on operations of her vision to transform HP's structure and strategy. She also resisted board efforts to name a strong chief operations officer to compensate for that weakness. As difficult as it is, successful CEOs immerse themselves in the details of their empires—or have a sidekick who does.

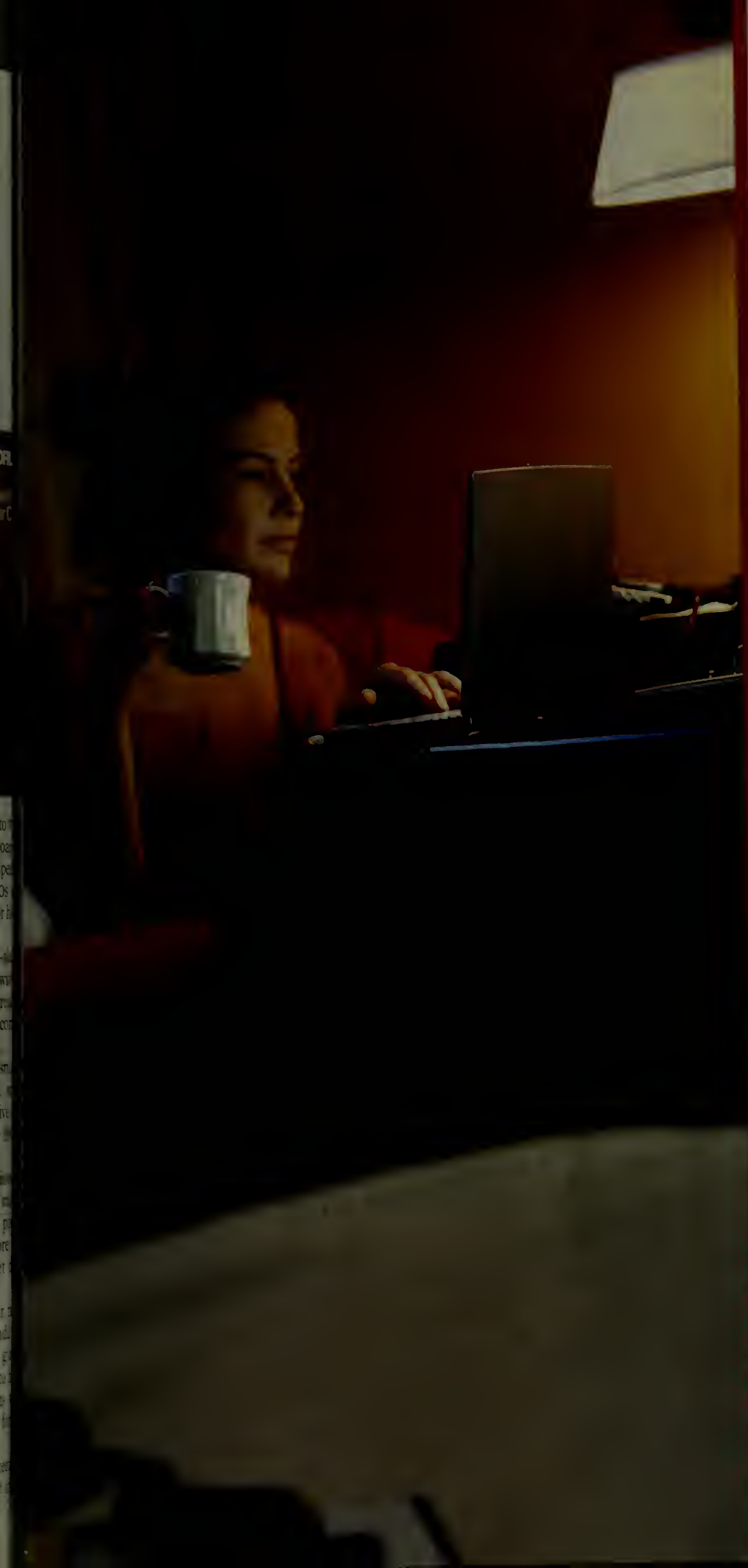
United Technologies Corp.'s George David is no back-slapper and lacks Fiorina's marketing flair. But he is obsessed with minutiae of production techniques that can make or break a company—and has quietly amassed an extraordinary record of straight years of higher profits.

General Electric Co. under Jack Welch was likewise a study in total management immersion. Talent, in particular, was a Welch obsession. He participated in hundreds of executive evaluations each year. If one slipped, he was among the first to know it, not the last.

HOLD PEOPLE ACCOUNTABLE—including yourself. Fiorina's decision to fire three top executives after the company missed third-quarter earnings targets last year went down poorly. Many inside the company thought it looked more like scapegoating and a way to assuage Wall Street than good management.

Contrast that with the dismissals of Louis V. Gerstner Jr. after coming to IBM in 1993. The first item on his agenda was to learn everything he could about the troubled tech giant's business, staff, and customers. So when it came time to hand out pink slips, workers had confidence that the cuts were necessary and that the right people were being fired for the right reasons.

Much of this sounds obvious, the sort of thing any executive should know by the time he or she reaches the corner office. What's surprising is how many of them don't. ■



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EDITED BY ANNE NEWMAN

HEADLINER

BILL GATES



SECURITY GATES

Always looking for new empires to conquer, Microsoft Chairman **Bill Gates** has set his sites on security software. On Feb. 15 he laid out plans to make computing safer for consumers and businesses, pushing Microsoft further into the \$10 billion security business. It plans to give away its newly acquired anti-spyware software, which vows to stymie programs that sneak onto PCs and steal personal info. And it will release a more secure version of its Internet Explorer Web browser.

Will the moves quiet critics who complain Microsoft's software is full of security holes? Not likely. The tactics are incremental at best—and unlikely to stem all the malicious programs flowing through the Net. But Gates has plans for that, too. Later this year, Microsoft will enter the consumer antivirus software market, squarely competing with longtime partners like Symantec and McAfee. "I'm optimistic that...we will be able to mitigate the security problems," Gates said. And maybe find a new niche for Microsoft in the process.

—Jay Greene

FDA, HEAL THYSELF

Stung by criticism from Capitol Hill, public health groups, and even some of its own staffers that it's incapable of spotting safety problems with drugs, the **Food & Drug Administration** is scrambling to change its ways. The latest moves: On Feb. 15, the White House said the FDA will set up a new drug-safety board to oversee medicines on the market. Such a body, the agency hopes, might lead to faster action on drugs like Vioxx, which was withdrawn after being linked to heart problems and stroke. The agency also plans to get information to doctors and the public faster with a Drug Watch Web page. And on Feb. 14, the Bush Administration nominated acting head Lester Crawford to be the agency's official chief, providing some long-needed permanent leadership.

AIG: ANOTHER FINITE MESS



The blows keep coming for **American International Group** and its chairman, Maurice "Hank" Greenberg. On Feb. 14, the insurance and financial-services giant said it had received subpoenas from federal and state regulators regarding so-called finite insurance products that help

companies smooth earnings. AIG already paid \$126 million to settle federal charges regarding the sale of similar products, and now investigators are looking at whether it inappropriately used them elsewhere. On Feb. 15, two employees pleaded guilty to bid-rigging and price-fixing in a separate probe. The news has some investors clamoring for more transparency on transactions from Greenberg as well as more independent oversight. Says analyst Brandon Rees of the AFL-CIO's office of investment: "Shareholders should not assume AIG is out of the woods yet."

NO PACE LIKE HOMES

Housing proved surprisingly resilient in a snowy January, as new construction rose 4.7%, to an annual rate of 2.16 million, the highest in almost 21 years. December's number was revised to show a jump of 14.3% vs. the 11% gain reported earlier. Stronger job growth and mortgage rates still below 6% are fueling demand, but home construction will likely slow in coming months. Mortgage applications to buy homes and builders' sentiment have weakened recently.

AMERICAN FUNDS IN A FIX

The NASD on Feb. 16 charged the distributors of the **American Funds** with improperly directing \$100 million in trading commissions over a three-year period to 50 brokerage firms that were the top sellers of its mutual funds. The third-largest fund company, with \$656 billion in assets, American has been under investigation for more than a

year by the Securities & Exchange Commission and the California Attorney General regarding similar issues (BW—Feb. 21). American Funds says that stopped the payments in 2003, shortly before they were banned by the SEC. American may request a NASD hearing. Possible sanctions include fines or NASD expulsion.

ET CETERA...

- » The **NHL** canceled its 2004-05 season, a first for any major league sport.
- » **Yahoo!** and **Showtime** simulcast the Mar. 7 initial episode of *Fat Actress*.
- » Died: Lawrence Rawl, Exxon CEO at the time of 1989 Valdez oil tanker spill

CLOSING BELL

LeapFrog Enterprises fell with a splat on Feb. 16, sliding 10%, to \$10.90. Faced with stiff competition in its core educational toy products, the former Wall Street darling reported an unexpected loss for the holiday quarter as well as layoffs and an executive reshuffling.



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ED BY MIKE McNAMEE

Did Fannie and Freddie Outsmart Themselves?

OF WASHINGTON'S CARDINAL RULES is: Know when to hold 'em, know when to fold 'em. Banking and Capitol Hill sources say Fannie Mae and Freddie Mac, which beat back legislation in 2004 that would have put them under tighter controls, have indicated they're ready to fold and accept last year's Senate bill.

But it's too late. In the wake of Fannie's \$1 billion accounting scandal and revelation of fat bonuses, Republicans will launch an even more ambitious assault on the two mortgage giants. "We are going to pull all the wheels and spinners previously enumerated, plus a few new ones," says Richard Baker (R-La.), chairman of the House capital markets subcommittee. Last year, Senate Banking Committee Chairman Richard C. Shelby (R-Ala.) called for establishing a new independent regulator with the power to set capital standards, approve new products, and put government-sponsored enterprises (GSEs) like Fannie and Freddie into receivership in the case of severe financial difficulties. Now, he says, that's "a floor, not a ceiling. We're coming back with a different environment."

Far Afield

HOW DIFFERENT is the environment in an overhaul bill sponsored by Senator Chuck Hagel (R-Neb.). Hagel would curb severance payments to executives and restrict Fannie's and Freddie's activities largely to buying and securitizing mortgages from banks originate. "These behemoths have gone beyond their mission" of promoting homeownership, he says.

Even stiffer restrictions may be in store. Hagel is scrutinizing the fees the GSEs charge lenders when they guarantee loans. Giving a new regulator authority to review and limit these "G fees" could cut a lucrative source of revenue. White House officials, meanwhile, are mulling whether to limit the issuance of debt by limiting the

amount of mortgages they can buy and hold. That would reduce their risk—but put a lid on their shareholder-pleasing growth.

Fannie, whose lobbying was legendary under ousted CEO Franklin D. Raines, is keeping its head down. But don't expect the GSEs to quietly accept new strictures. Freddie is bouncing back from its 2003 accounting troubles and has added lobbying muscle, including Timothy J. McBride, formerly DaimlerChrysler's top lobbyist and a staffer for President George H.W. Bush. "Fannie and Freddie are wounded but not out of the game," says Diane Casey-Landry, president of America's Community Bankers, a trade group.

Fannie and Freddie can also count on Democratic allies to argue that limits will hamper the pair's ability to promote homeownership. "The regulator shouldn't be able to say 'no' to a new product unless it would interfere with safety and soundness," says Representative Barney Frank (D-Mass.).

Republicans, however, could get a fresh boost from ongoing investigations. The SEC and Justice Dept. are

still looking over Fannie's accounting, while the Housing & Urban Development Dept. is examining the Fannie Mae Foundation, which supports charities that create affordable housing. And the housing giants' current regulator is probing whether Fannie and Freddie colluded in setting mortgage fees. If more shoes drop, legislation to create a new regulator will move quickly—and Fannie and Freddie will look back at last year with even deeper regret. ■

—By Amy Borrus



SHELBY Coming down even harder on the mortgage giants

CAPITAL WRAPUP

DEM DEFECTORS SEALED KERRY'S FATE

President George W. Bush owes straying Democrats a big debt of gratitude for his 2004 reelection victory. According to a *BusinessWeek* analysis of new data on the party identification of American voters, released on Feb. 15 by the University of Pennsylvania's National Annenberg Election Survey, the Republican incumbent carried 13 states where self-declared Democrats outnumbered avowed Republicans, including the key battlegrounds of Ohio and Florida. Senator John Kerry (D-Mass.) won only two states where more voters are loyal to the GOP—Maine and Oregon. The worst cases of Democratic underperformance were in Kentucky, Oklahoma, and West Virginia. Colorado, a top Democratic target in 2004 and beyond, was the only red state where Kerry demonstrated more crossover appeal than Bush.

BUSINESS PUSHES FOR A NEW TRADE REP

Business lobbyists fret that no replacement for U.S. Trade Representative Robert B. Zoellick has yet been named despite a full roster of trade negotiations, many of which are already behind schedule. Zoellick is headed for the No. 2 job at the State Dept. Two possibilities for the trade position formerly worked together at the USTR under President George H.W. Bush: White House Budget Director Josh Bolten and former USTR Chief of Staff and White House aide Gary Edson. Bolten has been trade counsel to the Senate Finance Committee and general counsel for the USTR. But the President may not be willing to let Bolten leave the budget office.



ENERGY

THE OIL PATCH GETS SLIPPERY

Sure, the majors are raking in money. But new reserves are elusive

TIMES COULD HARDLY seem better for big oil companies. Buoyed by high crude prices, Western majors are reporting outsize profits. Stock valuations? They're

stratospheric (page 106).

But if investors knew the details of a recent auction of oil plots in Libya, they might temper their enthusiasm. Libya has thrown itself open for investment, and the oil majors of Europe and the U.S. have stormed in, hungry for a piece of the country's 25 billion barrels in reserve. At an auction Jan. 29 for exploration rights to 15 Libyan blocks, the bidding got so heated that the winners wound up with "extremely harsh terms

that will make it difficult for them to make profits," says Craig McMahon, an analyst at oil consultant Wood Mackenzie in Edinburgh. McMahon figures that for one block, No. 106, which was bid on by 16 companies and won by Occidental Petroleum Corp., the government is likely to capture upwards of 98% of the revenues, compared with around 80% on other deals in North Africa, where governments drive hard bargains. Occidental says McMahon's estimate is too high and that it's happy to get a stake in an underdeveloped oil patch. "The days that people had gotten used to, where oil was inexpensive and easily available—those days are gone," says an Occidental spokesman.

Libya's auction underscores the

strange state Western oil companies find themselves in. Problems are emerging in the midst of incredible plenty. The industry's record of replacing oil and gas reserves has turned lackluster. From Russia to Venezuela, investment terms and regimes are becoming less favorable. Governments angle for a bigger cut of oil wealth. "Despite the current appearance of riches, there are long-term trends that will have a negative effect on industry profitability," says J. Robert Maguire, co-head of global energy investment banking at Morgan Stanley in London.

Costs are rising fast. For instance, rates for deep-water drilling rigs have more than doubled in the past year, rising from \$75,000 to \$150,000 and above, says Lehman Brothers Inc. analyst Anthony M. Sedita. Some observers worry when the markets will notice that the industry is facing headwinds. "Nobody is asking the hard questions," says Faouzi Gheit, a senior analyst at Oppenheimer Co. in New York. "It is all forgiven thanks to the obscene profits they are making. Gheit thinks investor pressure on companies to gain access to more resources and slash costs will eventually drive a new wave of mergers—even if oil prices stay high. And if oil prices drop, the consequences could be severe.

REPLACING OUTPUT

GHEIT AND OTHER industry watchers believe major oil companies face some fundamental challenges. For starters, companies need to replace annual output

all over 100% to sustain production— a target many are struggling to meet, says Wood Mackenzie analyst Plummer. He reckons that Royal Dutch/Shell Group's reserve-replacement ratio has hovered at around 44% to 45% over the past five years, if the U.S. Securities & Exchange Commission's definition of reserves is applied. One consequence is that, in 2004, Shell's actual production of oil and gas declined by 3% from the previous year. Even BP PLC, considered one of the best-run of the major oil companies, fell short of the 100% goal in 2004. It replaced just 89% of its reserves by the end of the year. "Today is not a good time to be around" for reserves, says BP's John Browne.

Clearly, it's getting harder for companies to replenish the oil and gas they produce. The question is whether this is because they cut back exploration budgets in response to low oil prices in the '90s or because opportunities are running thin. The answer is probably a combination of the two. At any rate, the average size of finds dropped from 353 million barrels in the

The Oil Industry Faces Headwinds

Despite high earnings, Western energy companies have structural problems

Data: Morgan Stanley
Yukos, Mackenzie, Reuters, New York

1970s to 107 million since 2000, figures Morgan Stanley. "The law of diminishing returns is alive and well. We're drilling more to get the same volumes," says Arthur L. Smith, CEO of John S. Herold Inc., a Norwalk (Conn.) energy consulting firm.

The scramble for reserves is also accelerating the shift away from mature fields—such as those in the North Sea and Alaska—to developing countries such as

OLDER PRODUCTION ZONES

Wells in Alaska and the North Sea are in decline, so the industry is being forced to spend big money creating new ones in developing countries, where terms may not be as good.

SCARCE RESERVES

Companies are struggling to find enough reserves to replace

production. The average size of finds is decreasing.

FINDING AND DEVELOPMENT COSTS

They're rising due to the high cost of building new infrastructure, a shift to more capital-intensive projects such as tar sands and liquefied natural gas, and cyclical cost inflation.

Angola, Nigeria, Trinidad, or the states of the former Soviet Union. Companies have little choice but to make the change. Production in the North Sea and Prudhoe Bay in Alaska is falling, and they need to add new resources to maintain output.

But there are serious costs associated with moving into new territories. An oil zone such as the North Sea or the Gulf of Mexico is a vast network of fields, many of

RUSSIA

Fencing Off the Oil Frontier

For global oil companies desperate to replace their dwindling reserves, Russia is increasingly tipped as the next frontier. By some estimates, the country may be sitting on at least 200 billion barrels of the stuff, not to mention the world's largest reserves of natural gas. Russian oil is cheap to boot. Acquisition costs are around \$1.30 per barrel based on prices paid in recent deals, such as ConocoPhillips' September purchase of a stake in Lukoil. That compares with \$4.90 per barrel in the U.S., estimates Moscow investment bank Troika Dialog. So what's the catch? Unless you happen to be Russian—or partnered with a Russian company—many of the country's resources aren't for sale.

That, at least, was the gist of an announcement by Natural Resources Minister Yuri Trutnev. On Feb. 10 he declared that only companies that are 51% Russian-owned can bid for licenses in six major natural-resource projects this year. Among them are the Sakhalin-3 oil and gas field off Russia's Pacific coast and the Sukhoi Log gold deposit. Existing projects

will not be affected by the new rules.

For foreign oil companies, the announcement represents a whole new complication in an already complicated country. "This could change the opportunities for some of the bigger companies, which will ask if they want to invest billions in a project [that] they're not going to control," says Stephen O'Sullivan, co-head of research at Moscow investment bank United Financial Group. BP PLC, for example, has a 50% stake in a joint venture with Russia's TNK. The requirement that bidders be at least 51% Russian-owned would exclude the venture,

TNK-BP, from bidding for licenses unless it ceded at least a percentage point stake to its current Russian partners or teamed up with another local outfit.

Russia is playing a high-stakes game. Without outside capital, the country will probably be unable to develop fields in the Arctic, the Far East, and offshore at Sakhalin. Already growth in Russian oil production has started to slow as Russian companies cut capital spending because of higher taxes, fears related to the prosecution of oil giant Yukos, and export bottlenecks.

Perhaps the majors will swallow their doubts and follow the rules to get their hands on that oil. "We're still interested in Russia," says an Exxon Mobil Corp. spokesman. But if the big companies stay away, Russia's oil dreams will quickly fade.

—By Jason Bush in Moscow
with Wendy Zellner in Dallas

ON THE DECLINE



which share terminals, processing plants, pipelines, and other expensive pieces of equipment. In the North Sea, companies such as Total help maintain output levels by plugging newly discovered satellite fields into existing networks.

That's not the case in basins such as Tenghiz in Kazakhstan and Sakhalin in Russia. There, companies must invest not only in drilling but also in building fresh infrastructure at much higher prices. Morgan Stanley estimates that finding and development costs rose by 86% from 1999 to 2003, to \$6.70 per barrel of oil equivalent.

Meanwhile, some of the richest acreage remains largely off-limits to Western oil companies. With prices high, there's less incentive for countries with huge reserves of cheap oil, such as Iran, Kuwait, and Saudi Arabia, to cede opportunities to global companies. "We know by experience that it's easier for OPEC countries to open for foreign investment

Much rich acreage remains off-limits to Western outfits

when oil prices are low," said Thierry Desmarest, CEO of France's Total, in an interview with *BusinessWeek* last fall. No rapid opening in the Gulf area is likely.

To build up reserves, oil majors are relying more and more on acquisitions of known assets. BP's \$8 billion purchase of 50% of Russia's TNK in 2003 boosted reserves by 11%.

Other outfits are pursuing unconventional and more capital-intensive sources of oil and gas, from tar sands to liquefied natural gas to drilling in increasingly deep water. This, of course, drives costs up even further. International majors are also facing stiffer competition for deals from Chinese and Indian companies, which are willing to spend big to lock up energy supplies for their fast-growing economies.

In this environment it's tough to play catch-up after poor exploration results. That's what Shell is racing to do. The company is hiring 1,000 exploration and production personnel and focusing its \$15 billion per year capital spending on boosting reserves. Those engineers will undoubtedly find more oil. Whether it will be enough to keep the party going is another question. ■

—By Stanley Reed in London

COMMENTARY

BY JASON BUSH

Deciphering Putin

Autocrat? Democrat? The truth is more complex

IT'S GETTING HARDER and harder to figure out Vladimir V. Putin. At times the Russian President looks like the reincarnation of a Soviet-era dictator, restricting the media, abolishing regional elections, and interfering in a neighboring country's election. At other times he acts like a bold market reformer, rising the ire of *babushkas* from St. Petersburg to Vladivostok by cutting popular communist-era benefits such

as free transportation and medicine for retirees and veterans.

Which Vladimir Putin is real? Which side of his personality will be dominant in the remaining three years of his second term?

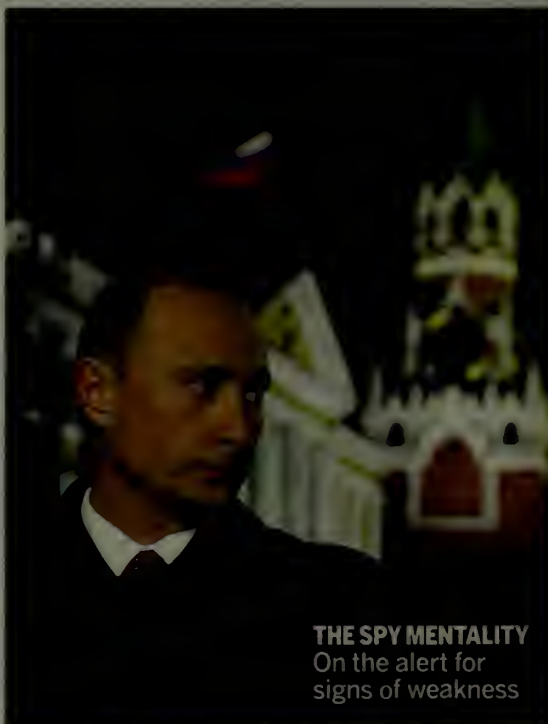
Those questions will be much on the minds of George W. Bush and his advisers when they meet with Putin and his entourage in Slovakia in late February. This meeting, with suspicions building on both sides, will be a far cry from their earlier get-togethers when the two

seemed to be forging a new era in Russia-U.S. relations. Any further progress with Russia depends on having a better understanding of its complex leader. Here are some of the assumptions the West now makes about Putin—and a complex reality that makes any definitive statement about him impossible.

ASSUMPTION 1: PUTIN WANTS TO BRING BACK THE SOVIET ERA.

Putin, 52, has no secret agenda to restore the communist past. His generation grew up under Soviet leader Leonid Brezhnev, when communist ideology was already a joke, and educated young Russians envied the freedoms and prosperity of the West. "Putin is a very international person, and he wants Russia to be Westernized," says Sergei Markov, a Russian political scientist close to the Kremlin.

So why do so many of his policies now seem to be doing exactly the opposite? In part, Putin's personality may be to blame. Although outwardly unemotional and logical, Putin can become passionate and unyielding when someone gets in his way once he has decided on a course of action. "He'll wait, and then crush you like a steamroller," says Sergei Kovalev, a Moscow psychologist who specializes in profiling



THE SPY MENTALITY
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politicians. Fear of weakness is an overriding concern to him. "We showed weakness, and the weak get beaten," Putin told the Russian nation after the terrorist attack on Beslan.

Putin's background in intelligence has reinforced his innate love of order, hierarchy, and organization. "His character and personality are definitely not those of a dictator. But he is a perfectionist and a controller," says Alexander Rahr, director of the Koerber Institute on Russia & the CIS in Berlin and a biographer of Putin.

These characteristics help explain his drive to create a strictly hierarchical political system. The betting is that Putin will go further in this direction. Russian political analysts worry that Putin will abolish municipal as well as regional elections. Civic organizations that get funding from abroad are under threat from KGB types who see them as fifth columnists.

ASSUMPTION 2: PUTIN WILL NOT BROOK DISSENT.

It's a little more complicated than that. The ex-KGB colonel is, deep down, supremely suspicious of everyone's motives. "Putin thinks like a spy," says Markov. "If something bad happens, it's because someone did it deliberately." Political insiders say that Putin's decision to arrest Yukos owner Mikhail B. Khodorkovsky was not based on long-range economic strategy but on Putin's belief, encouraged by his security advisors, that Khodorkovsky was plotting against him.

Fears that Western powers are conspiring to encircle Russia may help explain Putin's moves late last year to try to ensure that a pro-Russian candidate won Ukraine's election. And after Beslan, Putin hinted openly that forces in the West encourage Chechen separatists to weaken Russia. He often responds to criticisms of his policies by pointing out similar shortcomings, real or imagined, in the West. For example, he compared last year's rigged elections in Ukraine with the disputed 2000 Presidential race in the U.S. And he believes governments the world over wield control over the press. At a December press conference he defended his policies toward the media this way: "The state always tries to secure its interests [and] reduce the amount of criticism.... In this respect, Russia is no better or worse than other countries."

Such suspicions are typical for ex-KGB types, known in Russia as *siloviki* (men of power), says Olga Kryshtanovskaya, director of the Center for Elite Studies at Russia's Institute of Sociology. "*Siloviki* think that democracy is a fairy tale, that there's no democracy in the USA or in Europe, that everything revolves around oil and nuclear weapons," she says.

To be fair to Putin, his suspicions and cynicism are often grounded in reality. Unlike many a U.S. President, Putin has an

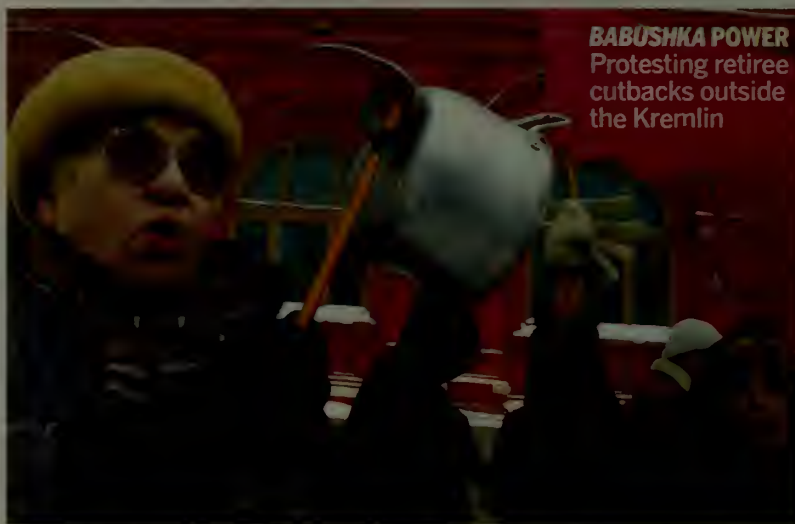
impressive grasp of facts and figures and can discourse hours on a range of subjects. It's clearly not paranoid to be that, left unchecked, corrupt oligarchs or Islamic militants represent a genuine threat to Russia's interest.

ASSUMPTION 3: PUTIN WILL BECOME EVER MORE REACTIONARY.

Putin's stubbornness and tendency to assume that all criticism is cynically motivated indicate that he isn't likely to backtrack on Yukos, Chechnya, or political reforms that centralize power. His habit of sticking to his guns cuts both ways, however. Putin is just as unlikely to sack his liberal minister or abandon his economic reforms, although he may face growing difficulties in implementing them. Likewise, Putin is unlikely to make dramatic shifts in foreign policy.

The good news: Ukraine doesn't seem to be an issue like Chechnya or Yukos, where he is simply deaf to reason. Putin has shown signs of his old pragmatism by moving quickly to rebuild relations with new President Viktor Yushchenko.

Another positive: Because the Yukos affair was caused by a specific conflict with Khodorkovsky, Putin doesn't seem intent on nationalizing all of Russia's big companies. However, a situation where



The Russian President is unlikely to back down on economic reforms

President's attitudes toward individuals can have such far-reaching consequences has the potential for more shock. Putin has already fallen out with three major oligarchs in many years. Before going after Khodorkovsky, he drove megabosses Boris A. Berezovsky and Vladimir A. Gusinsky into exile. This over-personalization of politics is a problem of the Russian system.

ASSUMPTION 4: PUTIN DOES NOT WANT DEMOCRACY.

Putin's cynical attitude toward democratic development may be simply a reflection of Russia's own backwardness. Putin "does not think Russian society is mature enough to take care of its own problems," says Lilia Shevtsova, senior associate at the Carnegie Moscow Center, a political think tank. "He believes what he is implementing is the Russian model of democracy." Yes, the president acts like a stern Tsar, but eventually a more democratic state is supposed to evolve—albeit with some traditionally Russian authoritarian aspects.

It's often forgotten or ignored, but Putin had power thrust upon him. He did not actively seek office, and the general feeling is that Putin does not crave the powers of a dictator. "People of this type are driven by a sense of duty," says Kovalev. But there is a caveat. Putin's unwillingness to delegate authority or develop independent political institutions will make it hard for him to step aside in 2008 even if he wants to. Can he break out of this self-created box? As with so many questions in Russia, the answer can only come from its enigmatic leader. ■

BusinessWeek online

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BRITISH AIRWAYS

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Why Iran Can Thumb Its Nose at Washington

VICE-PRESIDENT DICK CHENEY hints that Israel might attack Iran. Secretary of State Condoleezza Rice calls the Islamic Republic an "outpost of tyranny" with a human rights record that should be "lashed." President George W. Bush, in his State of the Union address, emphatically tells Iranians "as you stand for your

freedom, America stands with you." The reaction on the streets of Tehran? Ridicule. "He should sit down," goes one joke during the rounds; "he has been standing so long he must be getting tired."

Burning Hell"

WH WASHINGTON long on rhetoric and short on action, it's no surprise the Bush administration's threats to change Iran's regime and its nuclear program are cowering few Iranians. Not only is the public dismissive, the nation's leaders are defiant. "Our nuclear centers cannot be destroyed,"

Ali Khamenei, Secretary of Iran's Supreme National Security Council, stated on Feb. 8. Two days later, President Mahmoud Khatami vowed Iran would become "a burning hell" for any attackers. Says Amir Mohebbi, a conservative strategist: "The government has reached the conclusion that there's a very small chance of these threats being carried out."

That's a problem for the Bush Administration. The White House is betting that political change will transform Iran before Tehran

has the capability to produce nukes, which Defense Secretary Donald H. Rumsfeld predicts is "some years off." According to sources inside and outside the government, the Bush team hopes that the largely pro-American Iranian public will oust the mullahs, whose economic policies can't cope with rising youth unemployment.

The problem with this strategy? It's based on "a heroic assumption that a new regime won't want nukes," concedes an

Administration insider. In Iran there's a broad consensus in favor of the nuclear program, which the government insists is for peaceful energy purposes. The nuclear program is backed both by conservatives, who control the Parliament and are likely to win the presidency in May, and by reformists such as Khatami.

While waiting for a political overhaul, the Administration hopes the European-Iranian talks will manage to halt or slow down Iran's alleged nuclear weapons development. Yet the U.S. has refused to join talks that Britain, France, and Germany are conducting with Tehran. The Europeans want Iran to give up a uranium enrichment program and other activities that could lead to nuclear weapons. The U.S. wants no reactors at all in Iran.

The Administration's reluctance to participate in these bargaining sessions leaves it with few cards to play. The way things are going, "the Iranians will drive a truck

through the gaps" between the European and U.S. positions and "will emerge as eventual winners," predicts Geoffrey Kemp, an Iran expert at Washington's Nixon Center.

What's left? Rice says she would seek U.N. sanctions. But some combination of Chinese, Europeans, and Russians would probably torpedo any such action. The last resort would be military strikes by the U.S. or Israel. Experts think strikes would delay but not derail the program. With his Iran policy, Bush is clearly in a box—and hasn't yet found a way out. ■

—By Stan Crock in Washington, with Babak Pirouz in Tehran



DEFIANT Khatami backs Iran's nuclear program

GLOBAL WRAPUP

EUROPE'S NEW RULES ON IMMIGRATION

SPAIN'S AMNESTY program for illegal aliens is heightening tension over immigration policy in Europe. The Socialist-led government of Prime Minister José Luis Rodríguez Zapatero announced on Feb. 6 that it would grant temporary residence permits to illegal aliens who could prove they had been in the country at least 6 months, and had jobs and no criminal record. An estimated 500,000 to 800,000 workers could qualify. Although France and Italy in the past offered similar amnesties, most Western European countries now are pushing for stricter limits. On Feb. 7, Britain said it would begin fingerprinting people entering the country on visas and institute a point system that will screen out most unskilled workers seeking legal entry. Britain, Denmark, and Germany have expressed alarm that Spain's action could spur more immigrants to enter Europe illegally in hopes of later gaining amnesty.

FRANCE DECIDES TO OPEN UP FOR BIDS

LONGSTANDING barriers to competition within the European Union may soon tumble. On Feb. 15, French Finance Minister **Hervé Gaymard** announced plans to open up public procurement practices in water, electricity, transport, and postal services. France had agreed to the measures in 2004 as part of a \$2.6 billion rescue package for engineering giant Alstom. The pledge from Gaymard is a victory for the European Commission's new competition commissioner, Neelie Kroes. She threatened legal action against France because it hadn't yet honored its pledges on Alstom.

Game Wars

Who will win your entertainment dollar, Hollywood or Silicon Valley?

THIS UNUSUAL "PREMIERE" had the glitz and glamour of a Hollywood film debut. On Feb. 10, in New York City's Little Italy, Il Cortile, a restaurant decorated lavishly with faux alabaster statuary, was jammed with journalists, producers, corporate executives, and assorted hangers-on. Actors James Caan and Robert Duvall worked the red carpet, chatted with fawning TV folk, and posed for the paparazzi. The event: a sneak peek at the next installment of *The Godfather*.

But don't expect to see this sequel at the multiplex. It's a video game. Electronic Arts Inc., the maker of *Madden NFL Football* and *The Sims* video games, is borrowing some of Hollywood's marketing tricks in an effort to make its *Godfather* an offer you can't refuse. EA licensed the rights from Paramount Pictures and is hoping to build buzz in advance of the game's release before Christmas. The two companies joined forces to create a game in which players mimic the strategies of the Corleones. To climb the ranks in this crew of wiseguys, you'll need to use fear, violence, loyalty, and negotiating skills.

The convergence of Hollywood and Silicon Valley brings to mind another mafia credo: Keep your friends close, and your enemies even closer. EA and Paramount are pals today, but they might be fierce rivals tomorrow. The worldwide video game industry, with revenues of \$24.5 billion last year, overtook movie box-office receipts, and sales are expected to soar to \$55 billion by 2008, according to Price-WaterhouseCoopers.

While broadcast TV audiences dwindle and moviegoing stagnates, gaming is emerging as the newest and perhaps strongest pillar of the media world. So it's no surprise film studios, media giants, game makers, and Japanese electronics companies are all battling to win the Game Wars. "This is a huge shift we're seeing, and nobody wants to be left behind," says Sony Entertainment Chairman Michael Lynton.

The play is fast and furious. When EA on Jan. 18 spent \$800 million to lock up ESPN content such as X-Game sports competition for use in games for the next 15 years, it was just the latest jolt to an industry in which megadeals have become as commonplace as laser-toting ogres. Next came the news that Microsoft Corp. plans to produce the movie version of its *Halo* megahit video games, which have

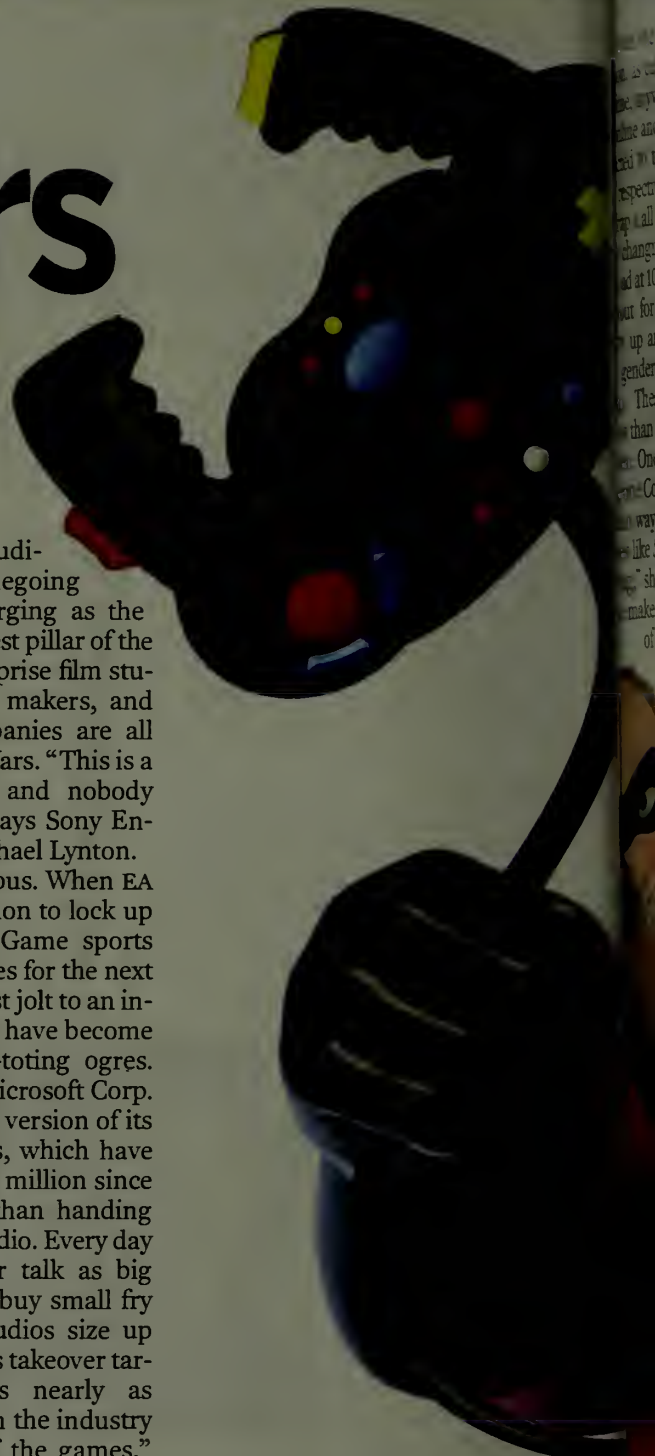
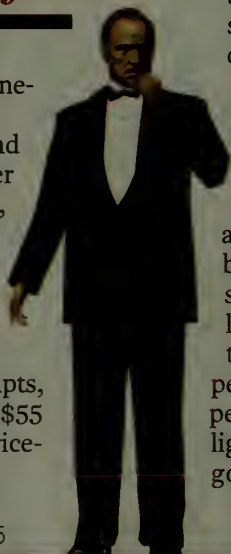
raked in \$600 million since 2001, rather than handing the job to a studio. Every day there's merger talk as big game makers buy small fry and movie studios size up game outfits as takeover targets. "There's nearly as much action in the industry as in some of the games," says Lorne Lanning, head developer for Microsoft's *Oddworld Stranger* game.

New gizmos promise to make the current crop of games look as quaint as *Pac-Man*. Sony, Microsoft, and Nintendo are racing to be first out with new consoles later this year or in early 2006. They'll boast chips that pack the punch of a supercomputer, delivering super-realistic graphics and lightning-quick controls. The goal: making gamers feel like

they're living their games, not just playing them. "The advent of new technology...always invigorates everyone in the industry," says EA Chief Executive Lawrence F. Probst III.

Consoles are only part of the story. Gaming is exploding in all directions going online, mobile, and global. On Web sites such as Microsoft's Xbox Live, 1 million hard-core gamers match up the reflexes in multiplayer shoot-'em-up games for bragging rights in cyberspace. Hip urbanites in China and South Korea are packing Internet cafés to play online games for as little as pennies per minute.

**Not coming to a theater near you:
A new *Godfather***



even the tiny screen is grabbing attention, as cell-phone titles take gaming home, anywhere. By 2008, the markets for online and mobile-phone gaming are expected to top \$15 billion and \$13 billion, respectively.

Wrap it all up, and you have an industry changing shape while it races down the road at 100 miles per hour. Once just a pastime for teenage boys, gaming has grown up and gone mainstream, luring both genders and every age and interest group. These days, more adults play games than kids, and 39% of gamers are women. One is 38-year-old office manager Renne Cohen of Tinton Falls, N.J., who has cut way down on her TV time to play games like *Star Wars Battlefront*. "It's addictive," she admits. As media giants and game makers try to win the Renne Cohens of the world, they're under intense pressure to outwit, out-

play, and outlast their rivals—all the while navigating a fickle consumer market.

There's money to be made in surprising new ways. In China, online leader Shanda Interactive Entertainment Ltd. is building an eBay Inc.-like marketplace to let players buy and sell game characters or new colors for that favorite Ferrari racing vehicle—with Shanda taking a cut. And with game demographics trending older, advertisers are leaping in, getting their messages across through product placements, billboards within games, and sponsorships—and even hiring developers to build "advergaming." LG Electronics of Seoul has sponsored an online car-chase game in which players use an LG videophone as they zoom after bad guys modeled on Fox's *24* TV show. The ad angle is so promising that Nielsen Entertainment is setting up a new service for tracking gamers' likes and dislikes.

TOPS IN TINSELTOWN

WATCH OUT, HOLLYWOOD. For now, at least, the big game-industry players are calling the shots. They know the business and have strong records creating

gaming hits—whether from movies or their own homegrown material. The game makers control armies of talented artists, engineers, and developers who understand the differences between interactive entertainment and passive viewing of movies and TV shows. And the console makers not only produce dozens of their own exclusive games but charge independent game outfits fees for every game sold that's designed for their console. The media companies are the newbies. Until they figure out how to design and market games more successfully than the game-industry leaders, they're going to be riding shotgun in this race.

Hollywood has no choice but to grab for the joystick, though. Not only do the media giants need the revenue growth, but games are siphoning off their most coveted customers: 18- to 34-year-old males. It's a generation that has grown up thinking of Madden as a game, not a football coach. What's more, the payoff goes straight to the bottom line: These days, the studios' operating profit margins average just 10%, according to investment bank Veronis Suhler Stevenson, while game makers average 15% and the best reap as much as 25%. When studios license a movie to a game maker, they typically get \$3 million to \$5 million up front against about 9% of the take. Not bad. But as the studios do a better job of creating their own hit games, they'll gain from both ends of the business, strengthening their hand in negotiating licensing terms as well.

It looks like the smartest strategy for players on both sides is to find partners. While the media companies need the game companies more, even the strongest game makers are looking to Hollywood for its bankable movie and TV properties. Success is going to require melding the talents and assets of both worlds. In the end, the winners will be those with the best and broadest portfolios of properties and alliances.

SCALING UP FAST

ALREADY, SOME strong players are pulling ahead of the weak ones. EA is a champ, for sure, thanks to its name-brand games and its ability to play well with others, such as Paramount and ESPN. Sony has the advantage of being the only company with a console, games, and movies, and it makes money leveraging those businesses against each other. And among the media giants, Viacom is an early favorite because of its scope and



DOUBLE SMASH
The *Incredibles*
looked in pixel
joysticks

track record of capitalizing on radical shifts—think MTV. Possible wild cards: China's Shanda and Korea's NCsoft Ltd. could extend their early leads as online pioneers in Asia and become global powers. Two big names most at risk are the powerhouses of family-friendly entertainment, Nintendo and Walt Disney Co. Both were slow to address the shift to older audiences.

It's all moving so quickly—and getting so expensive—that any company that wants to be a player had better get big fast. That's especially true for game makers. Not only are they bidding against one another to lock up rights to everything from movies to baseball stars to Arena Football brands, but costs for developing games are going sky-high. Five years ago, it cost about \$3 million to develop a high-end game; now it's \$20 million as games become more complex and require more artists and programmers. Microsoft spent \$40 million to create and market *Halo 2*. That's still far shy of the \$70 million average cost of a Hollywood movie, but it prices most small and midsize game makers out of the top of the market. "With a slate of releases each year, it's like rolling the dice with \$200 million every year," says Jay Cohen, vice-president for U.S. publishing at

Electronic Arts is king of the franchises, with 007 and Madden

French game maker Ubisoft Entertainment.

The top five game developers last year accounted for 56% of the industry's more than \$7.3 billion in U.S. software sales, according to investment banking firm Harris Nesbit Corp. And the strongest players are rushing to bulk up even more. No.1 EA, with \$3 billion in annual sales, in De-

cember bought a 20% stake in Ubisoft for \$87 million, eyeing its hit titles such as *Myst* and *Tom Clancy's Splinter Cell*. Rival Take-Two Interactive Software Inc., maker of the smash *Grand Theft Auto* games, in January responded by snapping up sports game developer Visual Concepts Entertainment from Sega.

NO MAGIC FORMULA

WITH ONLY 5% of all games reaching the 1 million "hit" mark, it's vital for game makers to build up a portfolio of winning franchises. That has been the key to EA's success. The Redwood City (Calif.) developer takes much of the risk out of game making by keeping customers coming back for their favorites. In addition to *Madden* and *Sims*, it has NASCAR, James Bond, and the *Medal of Honor* shooter series—totaling 27 game titles last year that sold more than 1 million copies. It found out early on that

sports fans are willing to plunk a \$50 every year for essentially the same game but with updated team rosters.

When it comes to dealing with Hollywood, EA has decided to make alliances rather than buy a studio of its own. It looked at buying a movie studio, but has relationships already with Columbia Line, Paramount, Warner, and MGM, says EA's Probst. "We think that's a better approach than owning one property being confined to that portfolio," when it decided to expand its portfolio of franchises, it bet on stories such as *Lord of the Rings* and *Harry Potter* that already had huge fan bases.

Still, nobody, not even EA, has a magic formula for what works and what doesn't in the new world of movie and game collaboration. Before he became governor, Arnold Schwarzenegger stumped for a video game released at the same time as his *Terminator 3* flick, but even he couldn't make the Atari Inc. game a hit. EA's *Woman* was a dud. On the other side of the coin, the video game *The Chronicles of Riddick* was a smash, while the Universal Studios film was a huge disappointment.

Psyching out the gamer mentality, particularly trying for Hollywood. tribulations go back to the '80s, when Warner Communications owned Atari. That experiment came to an ignominious

HOW THE COMPETITION SHAPES UP

With video games exploding, major players are scrambling to grab huge chunks of the business. Here's the handicapping.

LIKELY WINNERS

SONY The Japanese giant is a triple threat. It not only sells hardware and a huge catalog of games but also licenses the gaming rights to its movies such as *Spider-Man*. Its newest hardware designs promise to send the industry into overdrive.

ELECTRONIC ARTS The game software industry's 800-pound gorilla is getting even more powerful. In the past two months, EA has locked up some of the industry's most lucrative segments by signing exclusive multiyear deals with the National Football League, ESPN, and the Arena Football League.



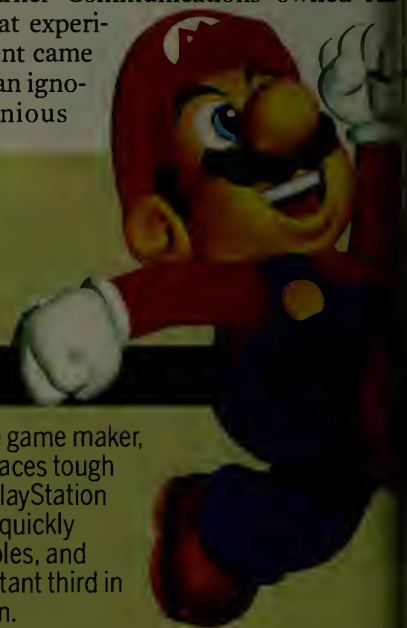
SUMNER REDSTONE The sharp-eyed Viacom CEO, who bought MTV two decades ago, last year personally took a controlling interest in Midway Games, maker of *Mortal Kombat*. Now his Paramount units are collaborating with Midway. The Paramount studio just agreed to make a movie from Midway's *Fear & Respect* game.

AT RISK

NINTENDO The venerable game maker, parent of Mario Brothers, faces tough competition from Sony's PlayStation Portable. Microsoft also is quickly earning its stripes in consoles, and Nintendo could place a distant third in the next console generation.

ACTIVISION The second-largest independent game developer has lucrative franchises such as *Spider-Man* and *Superman*, but its sports lineup has been weak. It's a juicy takeover target for a Hollywood outfit looking to land a fairly broad lineup of games in one fell swoop.

WALT DISNEY The Mouse House is trying to appear hipper by renaming its video game unit Buena Vista Games. Disney has tripled its game development budget to \$40 million annually and is looking into acquiring game studios, but there's little evidence it can become a major player.





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Entertainment Video Games

end in 1984 after Atari released the ill-fated game *E.T.: The Extra-Terrestrial* and gamers hated it. Five million game cartridges ended up buried in a landfill. Warner wasn't the only studio to stumble. In Hollywood's second foray into the game sphere, in the late 1990s, Viacom and Fox Entertainment Group had years of flops, while DreamWorks abandoned its game unit after only two years.

WEEKEND WONDERS

TINSELTOWN'S BIGGEST flaw was arrogance. Hollywood moguls looked down on the jeans-wearing geeks who were making the hottest games around. Instead, the "suits" saw the world in terms of nice, neat movie-like story lines—and didn't understand that in games, the players become actors in their own stories.

Game economics also threw them: While a studio could recoup the cost of a dud through home rentals and sales, pay-per-view, and cable and network deals, even the most wildly popular games typically sold well only for the first three months on the market. And many merely saw games as an extension of a movie or show instead of creating unique content for the gamer sensibility. The ultimate wake-up call that the game folks were really on to something came when Microsoft's *Halo 2* raked in \$125 million the day it went on sale on Nov. 9—better than *The Incredibles* movie did in its entire debut weekend.

It looks like the best bet for the media companies is to work with rather than fight the game makers—at least initially. That's the strategy of Viacom CEO Sumner A.

GIRL POWER

It's not just a guy thing anymore

THE STAT

39%

The percentage of video gamers who are women

Redstone. In fact, the octogenarian is emerging as Hollywood's No. 1 game fan. He doesn't play Donkey Kong or Doom himself—his idea of a good time is playing with his dog, Murray, and watching his tropical fish in his Hollywood Hills mansion.

But Redstone spotted games as a comer two decades ago, when they

were out of fashion, and began making personal investments in a company that's now Midway Games Inc., maker of the gory *Mortal Kombat* martial arts series. Since then he has watched the value of his 76% stake soar to \$670 million. During an interview at his home on Feb. 8, he recalled his prescient purchase of the fledgling MTV back in 1985. "I didn't have to be a teenager to see that MTV was going to change the world," he says. "And I don't have to be a gamer to see the cultural shifts that are coming with video gaming."

Now, Viacom's businesses are getting plugged into games, too. (Redstone recused himself from those discussions because of his conflict of interests.) The Paramount unit is working with Midway on projects—agreeing to make a movie from Midway's upcoming shooter *Fear & Respect*. Meanwhile, Viacom's Nickelodeon TV channel has moved aggressively to cross-market its key characters, including *SpongeBob SquarePants*

—and to create new ones for games.

Others in Hollywood are racing to forge their own alliances with the techie. Director Peter Jackson, creator of blockbuster *Lord of the Rings* trilogy, is working with Ubisoft to develop a *Kong* game that will come out at the time Universal's remake is released Dec. 14. And Pixar Animation Studios brought together its *Incredibles* creative team in January with THQ Inc. writers and artists to come up with a sequel to the game that will keep the story in the sumers' minds, even though a movie sequel has not been announced.

Some of the entertainment giants plan to go it alone. Warner Bros. Entertainment Inc. and Disney believe the better off owning game-development businesses rather than focusing on alliances. But this time around they plan tapping people who really understand games—and the game industry—to produce their titles. They are separately to be considering acquisitions of THQ, Activision, game makers with strong portfolios and proven records. "The question is whether to build or buy," Kevin Tsujihara, Warner's executive-president for strategy. "In the long run, we think it is better for the studio to be in control of the quality of a game built on an asset we've created." That's why Warner last year hired Jason Hall, co-founder of the Monolith Productions studio that's making an online version of Warner's *Matrix* movie, to start Warner's new game division.

Has Hollywood figured out the game business? Not by a mile. Disney, which had a game hit with its *Kingdom Hearts* game for young kids, is struggling to produce hits for older players. So now it's tripling its game budget, to \$40 million annually, to buy small companies and create games from films like Max Film Corp.'s *Kill Bill* series. Having its own in-house game-development operation could give it stronger leverage with game makers when they call, calling to try to license its properties—but only if it produces some bona fide hits.

In a sprawling market where controlling a broad portfolio of businesses is crucial, nobody is positioned better than Sony. Unlike any other players, it already has assembled all the pieces of a tri-



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video game empire. It sells hardware with its PlayStation consoles and is rolling out the PlayStation Portable handheld worldwide on Mar. 24. It makes games such as the popular *Gran Turismo* racing and *EverQuest* online. And it owns Sony Pictures and MGM movie studios, whose Spider-Man and James Bond franchises have been megahit games for Activision and EA. The combination has helped Sony sell 80 million PS2 consoles worldwide.

The real payoff for Sony comes in game software sales. While Sony and the other console makers sell their hardware for a loss, they typically make \$5 to \$10 in royalties for every game sold on their platform. PS2 has had more than 2,000 software titles, with more than 775 million total game copies sold. Sony courts independent game makers such as EA to make games exclusive to its console. And it develops its own games—exclusive software to keep fans loyal to the hardware. Sony's game business has for years propped up its consumer-electronics division, which accounts for two-thirds of the company's profits.

The biggest threat to Sony is not one of the traditional entertainment giants.

Consoles, games, movies—only Sony has it all

It's Microsoft. In the past year, the software giant overtook Nintendo as a strong No.2 in the high-volume U.S. market for game consoles with 24.9% share, vs. 56.4% for Sony and 18.7% for Ninten-

do. Analysts believe Microsoft will gain share, but they don't expect it to unseat the champ. Sony's next-generation technology is expected to out-dazzle Microsoft's, and it has a larger slate of exclusive games from the hottest small game studios.

But in this fast-morphing business, nothing is certain. A company that makes a wrong move could itself start looking like an ill-fated character in *Doom* or *Halo*—reduced to a smoking heap on the floor. With both opportunities and risks increasing each day, and new players vying for power, it will require all of the wiles and muscle of the Godfather to win. ■

—By Ronald Grover in Los Angeles and Cliff Edwards in San Mateo, Calif., with Ian Rowley in Tokyo and Moon Ihlwan in Seoul



CEO JORDAN
His plan could stabilize EDS finances

EDS Turbocharges Its Teamwork

Tight partnerships with a slew of tech biggies just might give it a shot at reviva

INVESTORS WHO TUNED INTO Electronic Data Systems Corp.'s fourth-quarter earnings call on Feb. 7 didn't hear a lot to cheer about. Sales and free cash flow at the troubled technology-services giant had fallen from the year before. New contract signings were way below expectations. Worse, the company offered a bleak outlook for 2005, with sales flat to down 3%. The next day shares of EDS sank 6%, to \$20.05.

But there was one bright spot. After three years of putting out fires, the Plano (Tex.) company finally unveiled a plan to revive growth. The centerpiece: \$1 billion in spending in 2005 to expand its service offerings, upgrade its technology, and beef up partnerships with Microsoft

Corp. and other tech leaders. That includes \$420 million EDS is plunking down in a joint venture with human-resources consultant Towers Perrin, which will let corporations outsource their man-resources departments. This marks the first time Chief Executive Michael Jordan has backed up his vision of growth with an investment plan, and some analysts think will improve EDS' competitiveness. "They need to spend," says analyst Cindy Shaw of Moors Cabot Capital Markets. "They're coming from behind."

Way behind. EDS has failed to increase sales in the past three years amid intensifying competition from giants such as IBM and low-cost rivals in India. Winning new business has been part of

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larily tough since EDS' financial woes have scared off prospective clients. EDS' new-contract signings were up 13% last year, to \$14.9 billion, but that's well below the 25% goal it had set a year ago.

Making matters worse, EDS may soon lose its grip on its largest client. General Motors Corp., which accounts for 9.5% of EDS sales, is renegotiating its decade-old outsourcing deal this year, and analysts say EDS could lose as much as two-thirds of its \$2 billion in annual fees from GM. A GM spokesman declined to comment. Jordan says that estimate is far too high but concedes that "we have a lot to prove."

Jordan may have more to prove than most. The former chairman and CEO of CBS came out of retirement two years ago to turn around the ailing company founded by the legendary Ross Perot. Jordan has little to show for his efforts so far, and the \$1 billion investment plan may be his last best shot. If it doesn't work, says analyst Gregory Smith of Merrill Lynch & Co., EDS may enter a "downward spiral" from which it won't be able to recover.

The plan does look like a solid step toward improving EDS' finances. Wall Street expects net income to rise 88% this year, to \$297 million, as revenues slip 2%, to \$20.1 billion. That's mainly because of cost-cutting and lower losses from problem contracts, such as a cash-draining outsourcing deal with the U.S. Navy. Next year, as Jordan's investments begin to generate higher margins from existing contracts and deals with new customers, analysts think net income will jump an additional 53%, to \$453 million. "It's taken a lot longer than we would have liked, but we've got a lot of confidence" EDS can rebound, says Clint A. Opperman, research director for Wisconsin Capital Management, which owns 2.1 million EDS shares.

Jordan is counting on more than a little help from his friends. He has a novel idea to sell EDS as the leader of a federation dubbed the Agility Alliance. The group features 10 key partners that have strengthened their ties to EDS since Jordan took over, including Cisco Systems, Dell, Microsoft, and Oracle. They have vowed to help EDS design new services in joint development labs, give it previews of future products, and lend their clout by jointly pursuing key contracts. An example: Storage giant EMC Corp. is working with EDS to develop a service to help customers manage their sprawling storage networks. "Our past al-

It's the first time Jordan has backed up his vision for EDS with cash

The Federation Of **EDS**

After two years of losing market share to rivals with more stable finances, EDS is strengthening its collaborations and investing \$1 billion to help it win new clients. The key ingredients:

BUILDING ALLIANCES To combat the breadth of rivals, EDS is teaming more with 10 key partners, including Cisco, Dell, and Microsoft. It is co-developing services and sales pitches, and each is pushing the others' products.

BRANCHING OUT With traditional computer outsourcing slowing, EDS is moving further into the specialized business of overhauling specific corporate functions, such as human resources and accounting. It recently created a joint venture with consultant Towers Perrin to offer clients human-resources outsourcing.

SLIMMING DOWN Nothing wins new customers like low costs. So EDS is cutting 15,000 to 20,000 of its 117,000 workers and streamlining its data centers and upgrading its networks so they operate more efficiently.

liances were meeting for a drink at a bar," says Jordan. "This is settling down, sharing an apartment."

EDS also is showing a new level of commitment. In the past it installed hardware and software from rivals such as IBM and Hewlett-Packard Co. if that's what customers chose. Now, EDS is encouraging customers to switch to its alliance partners' products, though it will support rivals' systems if customers demand it. Sun Microsystems Inc. and EMC stand to gain hundreds of millions of dollars in hardware sales if EDS clients switch from IBM and HP.

EDS' plan is about more than sales and marketing. Its tech staff is now teaming more closely with partners. At Microsoft's partner-development lab in Redmond, Wash., EDS' 50-person unit is the largest of any company's. Jordan meets with CEO Steven A. Ballmer once a quarter. "They are treating us like their own software house,"

says Simon Witts, vice-president for Microsoft's enterprise and partner group.

EDS is betting that the same collaborative mind-set will juice its fortune in business process outsourcing (BPO) of the hottest segments of tech services. The \$3 billion human-resources outsourcing market it is targeting with EDS' Perrin is expected to grow 21% annually through 2007 and offers higher margins than traditional computer sourcing. EDS will own 85% of the firm and consolidate its roughly \$600 million in annual revenue. EDS plans to invest \$100 million more this year to serve ventures with other partners to move the outsourcing of finance, accounting and procurement. Jordan's goal: double the revenues EDS gets from BPO, from \$2.7 billion now, over three to four years.

SIMPLE STRATEGY

RIVALS SCOFF AT Jordan's initial IBM and Accenture Ltd. have been investing heavily in the BPO market for years and have built up loads of expertise. IBM, for one, jumped into human-resources outsourcing two years ago and cut a year deal with Procter & Gamble Co. IBM helped it develop advanced technology payroll, benefits, and other services. IBM says its combination of hardware, software, and research prowess makes it a stronger partner than EDS. "They don't have the same capabilities we have," says Laurie Tropiano, a vice-president at IBM.

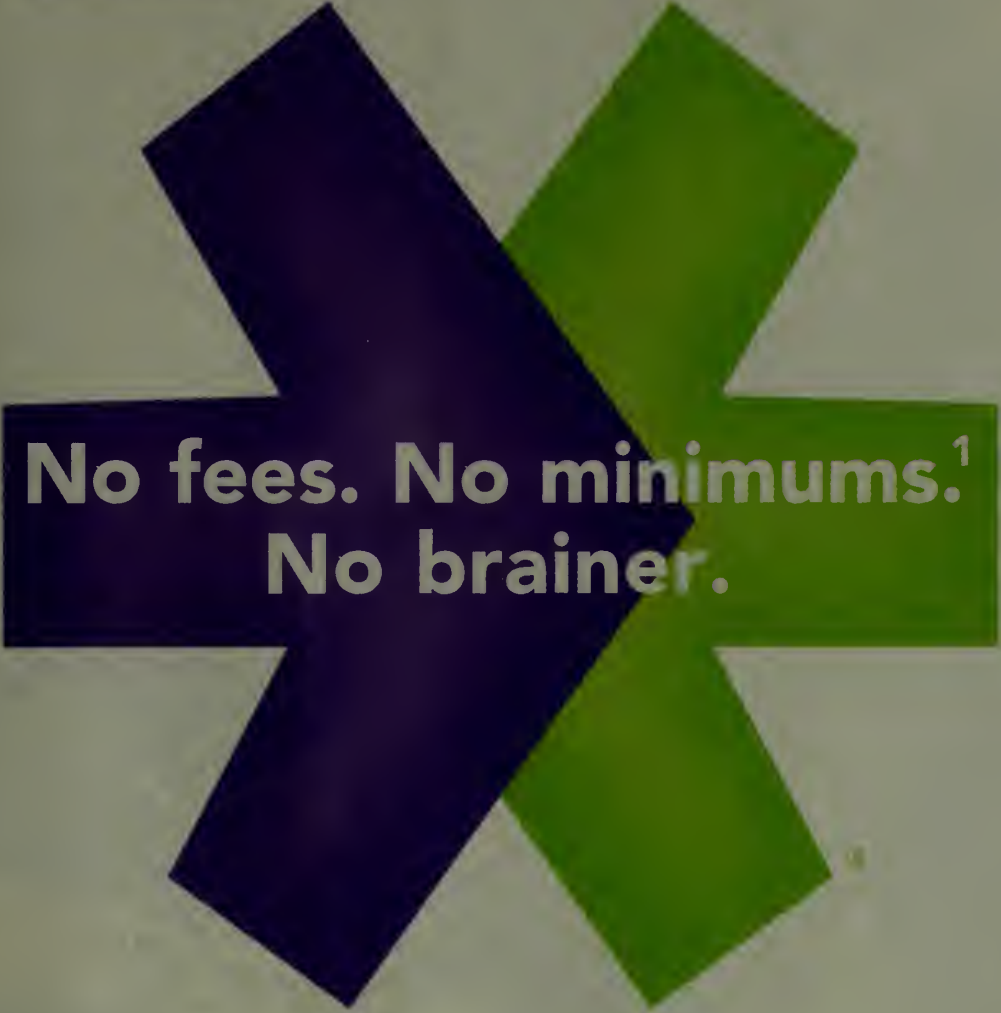
Still, Jordan's strategy appeals to buyers' hunger for simplicity and low costs. Take paper giant Weyerhaeuser. Thanks to EDS' alliance strategy, the company plans to hire EDS to integrate software, consolidate storage, and deploy Net phone systems. "Bringing all of that together in one place is going to greatly help us," says John Lorentzen, Weyerhaeuser's director for enterprise systems.

One customer a turnaround does not make. Yet Jordan's approach is resonating with some partners, too. When EDS stopped bidding on a contract for automaker DaimlerChrysler, a big Sun customer, Sun CEO Scott G. McNealy personally helped bring EDS back to the table. And last year, EDS plucked the deal from Big Blue. "The last thing we want to see is IBM win," says McNealy. For EDS, the enemies of its enemy are now its most important friends. ■

—By Andrew Park in Plano, Tex.
with Jay Greene in Seattle

BusinessWeek online For a Q&A with EDS CEO Michael Jordan, go to www.businessweek.com/extras

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EDITED BY
KENE WEINTRAUB

TS W, THAT'S A ACH MOTEL

ROACH TRAPS are vital in war against pests, but their models are sorely ineffective. The sticky boxes are designed to lure their victims with scents of chocolate and other foods. But often cockroaches ignore them. So scientists have teamed up to develop a trap containing the most universal of pheromones, sex. They've added a pheromone that lures German cockroaches to attract males. S.C. Johnson, a leader in pest-control products and a funder of the research, could someday use it to bait traps.



One of this was easy. The pheromone is not only scarce but also delicate. It can disappear under the heat generally used to isolate such compounds. So the scientists—from North Carolina State University and other schools—employed a new method of low-temperature gas chromatography to separate the molecule. Then they synthesized it and tested it on cockroaches. “They got really excited and ran right toward the pheromone,” says Coby Neal, a North Carolina entomology professor.



MEDICINE USING GENE THERAPY TO FIGHT DEAFNESS

THE DEAF CAN hear again—at least, if they're lab animals. Working with guinea pigs, University of Michigan researchers first killed off hair cells in the ear that translate sound waves into electrical signals, which is the basis of hearing. In humans, the loss of such cells is a common cause of deafness. The researchers then used a modified virus to deliver a gene to other cells in the ear. The gene normally is active only during the development of embryos, when it tells

immature cells to transform themselves into hair cells. But the researchers were in for a surprise: The copy of the gene they added was not only active, it was capable of instructing even mature ear cells to turn into the crucial hair cells.

Eight weeks after the novel gene therapy treatment, the animals were able to hear sounds. The scientists now need to determine what the animals are hearing and see how long the effect lasts.

—John Carey

PLASTICS A SIGN THAT FAILURE IS ON THE WAY

WHAT IF A MATERIAL could tell you it was about to fail? Your bumper might reveal that it's about to break from the stress of too many fender benders. Or the shrink-wrap around food could alert you to tiny ruptures, possibly protecting your family from illnesses.

Such failure-signaling plastics are being cooked up at Case Western Reserve University in Cleveland. A team led by engineering professor Chris Weder is mixing fluorescent dyes with standard

polymers to create low-cost plastics that not only glow under black light, but also change color when stressed. As the researchers showed with a snippet of modified fishing line (right), the more a material is deformed, the bigger the color change.

Weder's recipe is also good at producing very consistent color effects. This could help foil counterfeiters if, for example, bills or packaging were doped with a mix that produces a certifiable color. CWRU has applied for patents, and glowing products could be available as early as 2008.

—Adam Aston



TRANSPORTATION HE AIMS TO SHIFT INTO A BETTER TRANSMISSION

THE AUTOMATIC transmission is an engineering wonder. A “planetary system” of gears provides a wide range of speeds to the wheels, while letting the engine operate in the narrow range of speeds where it's most efficient. But it doesn't scale up too well. The transmission of a big truck can weigh 1,200 lb. It wears out quickly and is a notorious energy hog.

Josef Wodeslawsky, an inventor and president of W.J. Sunns in Englewood, N.J., has designed a transmission that overcomes those problems. He says it will be one-third the size and half the weight of today's transmissions, as well as longer-lived and 20% more fuel-efficient. The trick: One of the gears can roll backward, the way a person might walk backward on a moving walkway, to slow the forward movement of the vehicle in relation to engine speed. This lets the vehicle idle and then get going easily from a standing start.

The design does away with two problematic parts. There's no need for clutch pads, which overheat and wear out. Nor does it require a torque converter—an

inefficient, oil-filled gizmo that eats energy. Wodeslawsky, who expects to have a working version completed by this summer, is talking with potential customers in government and business.

—Peter Coy

(L TO R) PHOTOGRAPHS BY HOLT STUDIOS INTERNATIONAL/NIGEL CATTLIN/
PHOTO RESEARCHERS INC./CK HART/ARIEL HART/IMMAGINE CO./JONATHAN HARRIS

COVER STORY

BROAD CANVAS CEO
McKinnell insists
the blockbuster
model is still vital

A man in a dark suit and tie stands in the lower right quadrant of the frame, looking towards the camera. Behind him is a large, abstract, red and black geometric structure that resembles a stylized 'X' or a series of intersecting planes. The overall lighting is dramatic, with strong highlights and deep shadows.

Pfizer



Hank McKinnell helped pioneer the age of blockbuster drugs. But a dearth of new products and fears over drug safety are hurting the entire industry. Is there a fix?

BY AMY BARRETT

EVERY WEEKDAY, SOME 38,000 PFIZER INC. SALES reps fan out around the globe. Armed with briefcases full of free drug samples, reams of clinical data, and lavish expense accounts for wining and dining their quarry, the reps infiltrate doctors' offices and hospitals. Their goal: to persuade medical professionals the world over to make Pfizer drugs the treatment of choice for their patients' aches and pains.

This massive sales force—roughly the size of three army divisions—is just the advance guard in Pfizer's quest for world drug domination. Equally important is the drugmaker's \$3 billion annual ad budget. A pricey array of prime-time commercials and glossy magazine ads show vibrant people freed from the threats of heart disease, hay fever, and a dismal sex life. Sure, consumers can't just go out and buy this stuff: It has to be prescribed by a doctor. But Pfizer and the industry have learned that stoking demand among consumers puts irresistible pressure on doctors. That's why Pfizer is now the fourth-largest advertiser in the land.

GREGORY HEISLER

s Funk

Efforts such as these impose huge fixed costs. Pfizer, for example, now spends twice as much on sales and administrative expenses—\$16.9 billion last year—as it does on research and development. And it employs 15,000 scientists and support staff in seven major labs around world. As long as those labs are churning out a steady stream of blockbuster drugs for Pfizer's gargantuan sales force to promote, this mass-market approach is extremely profitable. Pfizer, which has more than its share of megasellers, including such familiar names as Lipitor, Viagra, and Zoloft, earned \$16 billion last year, not counting discontinued operations and onetime items, on sales of \$52 billion.

There's only one problem: The blockbuster model doesn't really work anymore. Pharmaceutical companies, Pfizer being the leader, have sent so many sales reps into the field that they're tripping over one another. The company's once-vaunted labs, along with those of most of the industry, have hit a dry patch, with introductions of promising new treatments slowing alarmingly. Some of Pfizer's recent launches have been duds. (Ever heard of Caduet or Inspra?) The diseases Pfizer and others now chase are harder to defeat with a one-pill, mass-market solution. HMOs and the like are putting the brakes on skyrocketing drug spending.

End of an Era

IT COULD GET MUCH WORSE. As *BusinessWeek* went to press, the Food & Drug Administration was holding contentious hearings about the fate of some of the biggest-selling and most lavishly promoted drugs—painkillers that include Pfizer's \$3.3 billion Celebrex and \$1.3 billion Bextra. Evidence is mounting that all these so-called Cox 2's—and not just Merck & Co.'s withdrawn Vioxx—may be linked to cardiovascular problems. Critics go further, though, arguing that Pfizer has not aggressively tried to answer that question—and in at least one case has not publicized important safety data on Celebrex. Even if the drugs survive, they are almost surely irreparably damaged.

Add it up, and it looks an awful lot like the end of an era. Big Pharma's sales are expected to grow by a sluggish 2.2% annual average through 2010, according to Datamonitor PLC. Pfi-

IN THE LAB Like other drugmakers, Pfizer has seen productivity decline



74.8 million

Lipitor prescriptions dispensed in the U.S. last year—more than 8,500 per hour

Data: IMS Health

zer's top line over that period will actually decline, by an estimated 1.5% a year. While Pfizer has posted strong earnings growth during Chairman and Chief Executive Officer Henry A. "Hank" McKinnell Jr.'s four-year tenure, much of that has come from cost-cutting in the wake of big acquisitions. That has caused investors to flee the stock, which has dropped 45% since he became CEO. "The pharmaceutical industry is in the process of transformation," says longtime Pfizer board member Stanley O. Ikenberry. "We have to reexamine all the assumptions that pharmaceutical companies have made for as long as I can remember."

That's why Pfizer has quietly circulated a memo telling its employees to brace for a restructuring that analysts expect will slash billions from the company's cost base. That's not to say McKinnell, 62, has accepted the end of the blockbuster era. While he acknowledges that Pfizer is heading into rough times, he also argues that the company is primed for a resurgence. And he has become the public face of an industry that these

days seems only one step above the tobacco business in public opinion. That's him on C-SPAN for an hour, trying to soothe callers irate over the high price of drugs. That's him calmly looking into the camera in TV ads as he explains how Pfizer scientists are pushing for cures for the greatest of human scourges. He simply won't cotton to the notion that his company's go-go years are gone-gone.

Quite the opposite. McKinnell argues that there are a host of untreated diseases that represent huge potential markets. He says Pfizer's internal research is presenting more great opportunities than ever before—indeed, the company is on track to file 20 new drug applications in the five-year period ending in 2006. And he boasts that a number of those are potential blockbusters.

Size, McKinnell believes, is especially advantageous as clinical trials become more complex and expensive. Who else but Pfizer, McKinnell asks, could afford to wager \$2.1 billion on what he thinks is the next megablockbuster, a heart disease



The Pfizer Formula Loses Its Punch

McKinnell bets on huge drugs...

TOTAL 2004 SALES:
\$52.5 BILLION DOLLARS
SALES FROM
TOP 5 DRUGS:
\$24.7 BILLION



...backed by a blitz of advertising...



...but now growth has hit a wall...



...pushing down Pfizer's stock price



Data: Pfizer Inc. SG Cowen Securities, Datamonitor PLC, Bloomberg Financial Markets

ing compound that goes by the chemical name torcetrapib? er is testing the drug in a combo pill with its current chol- erol fighter, Lipitor. And while this product is still three years y from the market, if tests show that it causes major reduc- of plaque in arteries of the heart, McKinnell believes it d eventually surpass Lipitor's \$11 billion in annual sales. "If orks, it will be the biggest blockbuster ever," says Mc- nell. As for those who argue that the blockbuster model is a , he has sharp words: "People who advocate that don't un- stand our business."

che Marketing

LL, THE SIGNS ARE ALL around him. He has seen the Age of gra pass as rivals crowded into the erectile-dysfunction field; s of that signature Pfizer product slid 11% last year, to \$1.7 on, far below initial projections. Nonetheless, Pfizer and its ppetitors keep anteing up more advertising dollars (page 82). gra is the leader, but the companies behind Cialis and Levi- are ceding nothing, making erectile-dysfunction drugs one he most heavily advertised categories on TV. McKinnell is left atching his head: "Normally a new entry creates new interest he market. That doesn't seem to be happening here. We cer- uly have the Viagra team trying to figure that out."

That's not to say there won't be blockbuster drugs in the future. McKinnell is right that there are some huge opportunities, such as an anti-smoking drug his labs are working on. But by and large, the diseases that remain without satisfactory treatments either represent smaller markets or are so complex that they defy one-size-fits-all solutions. Pfizer has a number of exciting cancer drugs in development, for example. While those may be decent-size products, cancer therapies typically aren't multibillion-dollar products sold by your neighborhood general practitioner. And as medicine moves toward more personalized treatments linked to an individual's genetic makeup, marketing will need to become even more sophisticated. What all this means is that there will be fewer \$1 billion-plus sellers that lend themselves to being marketed through the existing blockbuster sales machine that has sustained Big Pharma over the past decade.

This drying up of the pipeline exposes another challenge that drug companies face: They enjoy patent protection only for a limited time—10 years typically. After that they face an onslaught of cheap generic competition. Pfizer will see blockbuster drugs worth \$14 billion in sales per year lose their patent protection in the next three years. Even with the drug applications McKinnell has in mind, most analysts agree that there's not enough in Pfizer's labs to keep the company growing in the

\$7.7 billion

Pfizer's 2004 R&D budget—nearly as much as the combined budgets of Intel and HP

Data: Pfizer Inc. and *BusinessWeek*

face of those losses. And many of the drugs it's pursuing are the results of partnerships that will ultimately make them less profitable to the company.

The thing about the blockbuster model is that it gives you great leverage. But it cuts both ways. Each of Pfizer's sales reps costs close to \$170,000 per year including car, computer, and benefits, estimates Credit Suisse First Boston analyst Catherine J. Arnold. That figure doesn't change a lot if the company's sales are soaring or falling. So a big-selling drug can generate fantastic margins as sales ramp up. Pfizer generated an astonishing \$45 billion in gross profits last year. That works out to \$1.2 million per sales rep. Celebrex, with rich 90% gross margins, according to analysts, contributed some \$3 billion of that.

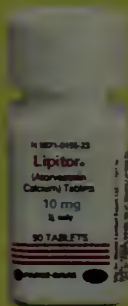
But watch what happens if those blockbusters fizzle. If Celebrex gets yanked from the market, profits per sales rep immediately drop to \$1.1 million—a 7% decline in productivity. If several drugs fall dramatically, which will inevitably happen as patents run out, and if others fail to take off quickly, that massive sales force could quickly become a massive millstone. Even without the unexpected loss of one of the blockbusters, Pfizer's

net income is expected to fall nearly 9% this year, to \$14 billion, as generics begin to launch and big franchises such as Cox-2 drugs take hits.

Clearly, McKinnell needs to do something. The Stanford University PhD in business, who blows off steam shooting his Sauer handgun as a guest at the FBI firing range in Quantico, Va., will soon take aim at a major restructuring. According to the late-January memo obtained by *BusinessWeek*, McKinnell has ordered a top-to-bottom review intended to make the giant more flexible and less bureaucratic. But don't expect to make big cuts in his sales machine. Sources say Pfizer's haul will entail having salespeople call on fewer doctors, talk about fewer products—with the goals of cutting down the repetitive pitches doctors get and making it easier to determine who's most productive. And the sales force will shrink, though largely through attrition and selective cuts. Employees have been told that decisions on cost reductions and the like will be announced to Wall Street around the April analyst meeting. Friedman, Billings, Ramsey & Co. analyst David Moskowitz figures McKinnell may slash as much as \$3 billion in expenses over the next several years.

Pfizer's Pipeline Problem

With many top-selling drugs soon facing cheaper competition, some of the company's replacements have uncertain futures:



DRUG	TREATMENT	EXPECTED '09 SALES
torcetrapib/Lipitor	Cholesterol	\$1.5 billion
Huge potential if data show that raising good cholesterol cuts deaths. But how many years will it take to get the data?		
Exubera*	Diabetes	\$1.4 billion
Analysts worry that safety concerns may delay its introduction.		
indiplon*	Insomnia	\$1.4 billion
Sleep drugs should be a big market—but many rivals are also jumping in.		
Macugen*	Macular degeneration	\$815 million
Launching this quarter. Pfizer has a head start but may see competition in the next few years.		
varenicline	Smoking	\$400 million
Strong demand for drugs that help you quit, but smokers tend to prefer them over the counter, not by prescription.		
Lyrica	Neuropathic pain	\$250 million
Sales may be limited because it has been deemed a controlled substance by regulators.		

Data: *BusinessWeek* and *BusinessWeek*

Radical Restructuring?

PFIZER, THOUGH, MAY REQUIRE more radical surgery. A smart move would be to inject the sort of bottom-up decision making into Pfizer that has worked so well at companies such as Johnson & Johnson. Decentralization might be a better match for a company that figures to have a more diverse portfolio of products requiring more targeted sales strategies. That would be a huge shift for famously top-down Pfizer. McKinnell says Pfizer has begun using a similar approach for product planning, linking managers from drug discovery through licensing, focused around specific disease categories, such as cardiovascular or metabolic disorders. He says that sort of structure eventually could be pushed across the entire company, in effect creating a series of smaller, more focused businesses. In the memo to employees, Karen L. Katon, president of global drugs, and Chief Financial Officer David Shedlarz wrote: "Many of you have expressed frustration with processes that are getting increasingly cumbersome, and with decision-making that seems to be slowing down. We share those frustrations."

Even bolder would be a diversification into other health-care businesses to reduce the reliance on pharmaceuticals. Pfizer was just such a beast not that long ago—in the early '90s it sold everything from heart valves to perfume. Former Chairman and CEO William C. Steere Jr. divested most of those businesses to focus on the high-growth drug operation. That set the stage for Pfizer's hot run. These days, though, medical devices are a high-growth business. The problem is, if Pfizer bought a device business today, it would pay a stiff price, since many device makers have seen their shares bid up. Buying another big drug company would be tough, too, since it would make Pfizer's revenue base even larger, compounding the challenge it now faces in expanding that top line.

A more likely path is for McKinnell to go shopping for drugs to shore up Pfizer's portfolio. He certainly has the financial means

2003



2004



2005



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38,000 Pfizer sales reps worldwide—the equivalent of about three U.S. Army divisions

cle—Pfizer is expected to generate \$10 billion in free cash flow in 2005 and may repatriate as much as \$38 billion in overseas profits to take advantage of a one-time tax break. That's money McKinnell can put to work licensing drugs or buying up smaller companies.

One way or another, though, Pfizer has to address its dearth of new blockbusters. Like others in the industry, Pfizer has been plagued by declining productivity in its labs. According to SG Cowen Securities Corp. analyst Stephen M. Scala, Pfizer spent about \$70 million on each product in its pipeline in 2004, up from \$53 million just two years earlier. That is slightly higher than the \$65 million average for the companies Scala follows. And a number of the most exciting products in the pipeline were either acquired or licensed—a sign of the weakness in Pfizer's early-discovery operations. Its last blockbuster that was discovered in its own labs: Viagra, launched in 1998.

That's why investors are so skeptical that McKinnell can get Pfizer back to its teens-plus revenue growth of the 1990s. Says portfolio manager Edwin C. Ciskowski at money-management firm Broadview Advisors: "It's a mature company with modest growth prospects."

Even Pfizer's potential hits won't help as much as you would think. To understand why the company is essentially running in place, look at its huge gamble on torcetrapib. The compound, which is supposed to raise HDL, or "good" cholesterol, is being tested at a cost of \$800 million, with Pfizer spending \$1.3 billion more to acquire a biotech company that is developing an-

other HDL-raising drug. No product is more critical to Pfizer since it will take a big hit when Lipitor, which contributes of current earnings, loses patent protection. But even if the drug is a home run and trials show the combo reduces heart attacks and death, ultimately it is a replacement, not a driver of new growth.

Patent Challenge

THE LAUNCH OF THE PILL, expected in 2008, could become a lot more difficult if Pfizer loses a critical patent challenge. Indian drugmaker Ranbaxy Laboratories Ltd. succeeds in knocking down both Lipitor patents—which is seen as a long shot—a generic Lipitor could hit in 2006. If Ranbaxy wins on one of them, which some observers expect, generics could arrive as early as March, 2010. Either way the loss would make it much tougher to get people to switch from a cheap generic Lipitor to a more expensive combination of Lipitor and torcetrapib. Credit Suisse's Arnold figures if Pfizer loses on both challenges its stock, now at \$25, would be worth \$18. McKinnell says confidently Pfizer will win on both decisions.

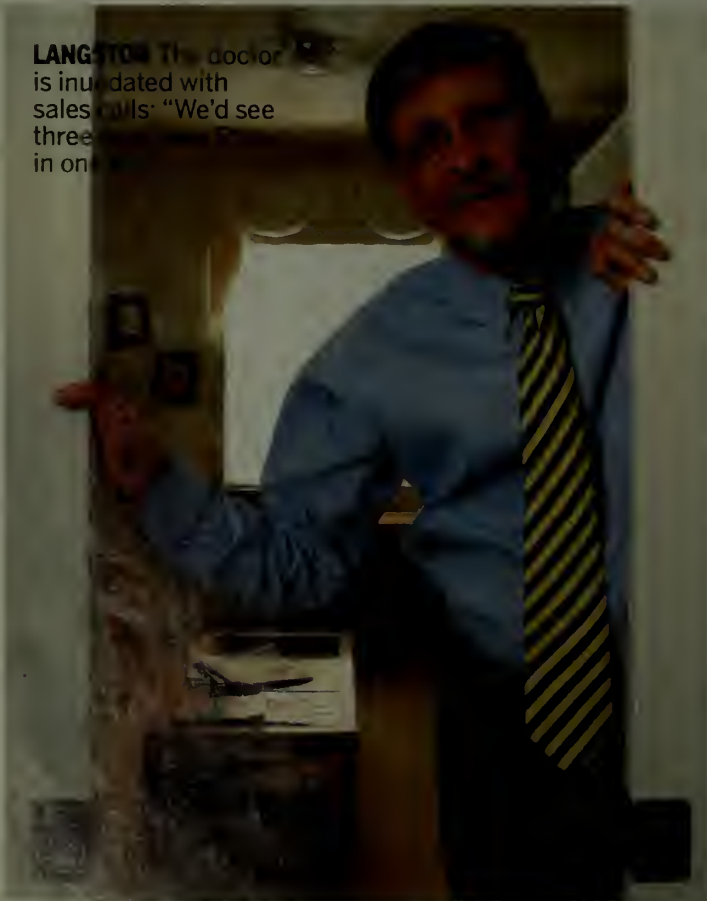
Clearly, all this is hard for McKinnell to swallow. He is, after all, the architect of the bigger-is-better strategy. He played a key role in the acquisition of Warner-Lambert Co. in 2000 and the Pharmacia Corp. purchase in 2003. McKinnell, well known as a quick study, has no shortage of confidence in his Pfizer and his own abilities. In a recent interview, he explained how working with an executive coach helped him learn to jump in with an answer before someone has finished asking a question. "My mind works pretty fast, and I tend to know your question before you ask it," McKinnell says matter-of-factly. He says he now listens to the full question, pauses, and then answers.

McKinnell's faith in the Pfizer way is well known. Anthony Wild, former president of Warner-Lambert's drug operations and now head of a small drugmaker called Medpointe Inc., calls working with McKinnell on the integration of their companies in early 2000. During a dinner in a Paris restaurant, Wild says, McKinnell observed that as he toured and met with Pfizer and Warner managers, he became more convinced that Pfizer managers might be the best choice for key positions in the combined company. Wild says the Warner executives in attendance were stunned, taking the comment as an indication that they had no future with Pfizer. "I saw a few jaws dropping," Wild adds. McKinnell says he doesn't recall the incident. But in the end, most of the Warner managers left or were let go.

That blunt style is well known within Pfizer. Shortly after taking over as CEO in early 2001, McKinnell made clear his concerns about the R&D productivity problem in a meeting in Houston with Pfizer's top 300 scientists, including R&D chief John L. LaMattina. Known inside Pfizer as the "Houston, we have a problem" speech, McKinnell used that line to make it clear the labs weren't delivering as they should. He says he meant it as a wake-up call: "They were busy congratulating themselves on opening new buildings."

The group, which had already created a task force to figure out what it could learn from previous drug-development flops, responded with a system to ensure that when it came to compounds in development, they had a good balance between

LANGSTON The doctor is inundated with sales calls: "We'd see three..." in one...



2005 Car and Driver's Best Luxury Sedan.



ever have you felt so pampered without having to tip somebody. Apparently, there are no luxury limits. Introducing the all-new Acura RL, featuring a Bose DVD-Audio surround-sound stereo, Bluetooth® hands-free phone technology and the first real-time traffic monitoring system*. Experience a world of sophistication and refinement in a gratuity-free environment. Visit acura.com, or call us at 1-800-To-Acura. **The all-new RL.  ACURA**

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\$3 billion

Pfizer's annual advertising budget—the fourth-largest in the U.S. as of 2003

tally novel approaches and less risky ones. They also came up with a series of tests that might help identify duds earlier.

But that solves only part of the problem. Since many of the drugs that do succeed are apt to be smaller and more targeted, they will force a big shift in the way Pfizer sells those drugs. While the company does have salespeople selling to specialists today, that sales force is dominated by reps who pitch a lot of drugs to a wide swath of practitioners. In the future, Pfizer will need more in the way of small, highly trained SWAT teams to target doctors focused on a particular disease. That approach will undermine a lot of the economies of scale Pfizer has enjoyed in the past.

Wide Sales, More Risk

EVEN NOW, PFIZER'S MASS approach to the market is taking some major hits. For one thing, rivals have caught on. Pfizer was one of the most aggressive drugmakers in building up its army of reps in the 1990s. But with an explosion in numbers across the industry, it's getting harder for any one salesperson to get face time with physicians. The number of U.S. reps grew nearly 8% from 2002 to 2004, according to research firm Verispan LLC.

With so many sales reps on the prowl, doctors have been absolutely besieged—and they're starting to push back. Dr. Edward L. Langston, a physician in Lafayette, Ind., says his practice had to institute a policy last year to restrict when salespeople could visit and where in the office they could talk to doctors. "We've had multiple times where we'd see three reps from Pfizer in one day," he says. Pfizer's Katen says she hasn't seen a drop in productivity. But Sanford C. Bernstein & Co. analyst Richard T. Evans says: "They are all committing death-by-salesperson."

As Pfizer evolves into a company with a bigger portfolio of a greater number of targeted or niche products, its massive marketing arm could weaken. In 2003, Pfizer shelled out \$2.9 billion—behind only General Motors, Procter & Gamble, and Warner, according to *Advertising Age*. But many of the new medical advances are in areas such as oncology, ophthalmology, virology, where treatments vary from patient to patient and lend themselves to a cutesy 30-second sales pitch.

The dangers of mixing glib advertising and medicine are more obvious than ever. Consider Pfizer's Celebrex and Merck's Vioxx, two next-generation painkillers. The much-ballyhooed benefit of the drugs when they were launched in the late 1990s was that they were safer on the stomach. But according to a recent paper published in the *Archives of Internal Medicine*, more than half of the growth in the market for these Cox-2 drugs from 1999 to 2002 was sales to patients who were not at risk of stomach problems and who could have taken older, cheaper drugs safely. No doubt some of that sales growth was driven by the drugmakers' heavy promotion and advertising.

Now it's clear that broadening the market carries with it grave risks—legal as well as medical. With Vioxx pulled from the market and Celebrex also showing evidence of a link to heart attacks, plaintiffs' lawyers are gunning for Merck and Pfizer. Merck's legal bill could approach \$20 billion. Pfizer's liability is less clear. The Justice Dept. and a group of state attorneys general have requested information on the safety and marketing of Celebrex and Bextra. If the evidence suggests that Pfizer knew more about heart risks than the company has admitted, it could lead to hefty penalties. In fact some critics have argued that the company did not publicize an earlier study looking at the use of Celebrex in Alzheimer's disease.

Henry A. McKinnell Jr.

The Pfizer lifer has been a promoter of the bigger-is-better approach throughout his career:

BORN Feb. 23, 1943, Victoria, B.C.

EDUCATION Bachelor of Commerce, Transportation, and Utility, University of British Columbia, 1965; MBA, Stanford University Graduate School of Business, 1967; PhD, business, Stanford, 1969.

CURRENT POSITION Chairman and CEO of Pfizer Inc. since 2001.

CAREER TRACK Started in 1971 as an assistant to the Japanese president of a Pfizer joint venture in Tokyo. Ran Pfizer businesses in Iran and Japan before moving to headquarters in New York City in 1984. Later jobs included chief financial officer and head of the global pharmaceuticals group.

MODUS OPERANDI Made his mark managing tough integrations. Merged Pfizer's U.S. and international drug operations in 1996 and was a key architect of the Warner-Lambert acquisition in 2000.

EARLY YEARS The son of a ship captain in western Canada, McKinnell spent his teen years working as a deckhand on freighters. He later earned cash driving in Canadian rally races and closed-track auto races.



HOBBIES An avid hunter and fisherman. Classified as an expert marksman, he occasionally trains at FBI and Marine Corps shooting ranges in Quantico, Va.

1982 McKinnell (right) at a manufacturing facility in India

SELF-IMPROVEMENT Has worked for 10 years with a management coach to soften his sometimes hard-edged style. McKinnell now sends holiday cards to colleagues with personal thanks for a specific contribution or accomplishment.

FAMILY Divorced, with four grown children. Engaged to Joanna Slonec

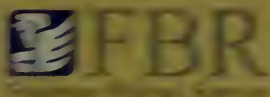
A woman in a dark wetsuit stands on a sandy beach, holding a surfboard under her arm. She is looking towards the camera. The background shows the ocean with waves and a rocky coastline under a clear sky.

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showed more cardiovascular problems in patients getting the drug than in those taking a placebo. Pfizer says the data were shared with the FDA and that the higher rates for Celebrex may have been the result of differences in cardiac health between the Celebrex group and the placebo group. Even McKinnell is critical of pharmaceutical ads. "Somehow we created an image that these products are totally safe," he says. "We need to communicate in the advertising that no drug is absolutely safe."

Overly aggressive marketing also has made drug companies easier targets politically. And that pressure will only grow—particularly after the government starts paying for prescription drugs for seniors in 2006. McKinnell speaks passionately about trying to educate politicians on the cost-effectiveness of drugs. But it's a hard sell. The company invested nearly \$20 million in

a program in Florida that was intended to show that better utilization of drugs would actually save the state money. It didn't work, but not enough to deter lawmakers, who are demanding Medicaid price cuts.

Big Pharma's blockbuster business model may be wobbling, but McKinnell remains defiant, insisting that he will find a way to snap Pfizer out of its malaise. "We are willing to run experiments. Things that don't work, we stop, and things that do work, we press on," he says. "And we are exceptional in execution." Maybe so, but this is one ailing patient whose condition defies a simple cure. ■

BusinessWeek online For a Q&A with Pfizer CEO Henry McKinnell, go to www.businessweek.com/extras

The Little Blue Pill—And Pals—Have the Blues

Judging by the tons of TV and print ads that pitch erectile dysfunction drugs, you would think the big three—Viagra, Cialis, and Levitra—were selling as briskly as beer at a football game. After all, what could be more marketable than a pill that helps aging men perform better in bed?

It's not working out that way. Despite gargantuan ad budgets, sales are trailing expectations for all three contenders. Viagra's worldwide sales fell 11% last year and, at \$1.7 billion, were less than half what was projected by Wall Street firms a few years ago. Cialis and Levitra drove the category up 10% in the U.S. But Wall Street analysts—some of whom had speculated years ago that Viagra alone would be a \$4.5 billion brand by 2004—aren't impressed. Cialis, marketed through a joint venture between Eli Lilly & Co. and Icos Corp., rang up U.S. sales of \$203 million in its first full year and spent \$165 million on ads. And GlaxoSmithKline PLC's Levitra, co-marketed until recently with Bayer, sold just \$128 million worth of pills, well below what the companies spent on TV, print, and other media. Combined, the three spent 37% of their sales on ads, according to TNS Media Intelligence. Compare that with Ford Motor Co., which spent about 7% of U.S. automotive revenue on media last year.

Viagra's drop has been much steeper than anyone predicted. When it came on the scene back in 1998, Viagra was a textbook case in how to market a prescription drug as a consumer product. In less than two years,



Pfizer Inc. cemented the name into the popular lexicon in a way that marketers only dream about. "I've hardly ever seen a brand franchise in any category take off so fast," says Los Angeles marketing consultant Dennis Keene.

The reality today is much different. Less than 15% of the estimated 30 million men suffering from erectile dysfunction (ED) have tried one of the drugs. Matthew G. Beebe, brand team leader for Cialis at Lilly, says that many are still embarrassed to ask their doctor about the drugs. Another problem is that too many patients are disappointed when they take the pill and nothing happens. Dr. Timothy Schuster, assistant professor of urology at the University of Michigan Medical Center, says many patients don't use the right dosage. He adds: "A lot of doctors don't make the connection between ED and underlying disease like cardio-

vascular disease and don't engage patients.

But drugmakers can also blame themselves for lagging sales. In their rush to grab more of the market, they flooded doctors with free samples. Last year, up to 40% of the pills taken by men were free, says pharmaceutical research firm ImpactRx. And clearly, the ad-fueled hype stoked some early demand from those who

SLUMPING SALES
Two of the brands' revenues barely cover ad outlays

were more curious than afflicted.

Much of that hype has now faded—but don't expect pillmakers to

back off. Viagra's latest ads have men playfully sprouting blue horns the same color as a Viagra pill. The Food & Drug Administration slapped Pfizer's wrist last fall making it withdraw some ads that the agency said overpromised and failed to give adequate warning about side effects. Cialis has taken a more romantic approach, with middle-aged couples canoodling, to emphasize the drug's 36-hour working time (compared with Viagra's and Levitra's four-hour windows of opportunity). Levitra has the steepest hill to climb because it works about the same as Viagra but has less brand recognition. Bayer passed U.S. marketing control last year to GlaxoSmithKline and Schering-Plough Corp. In January, Glaxo and new partner Schering-Plough tapped Saatchi & Saatchi to scope out a different direction.

So far, the passion pills haven't had to worry much about decency standards on TV networks. NBC says it won't run the ads on "family" shows, but the drug companies aren't interested in those programs anyway. "We aim where the men are," says Lilly's Beebe. But hitting them with Cupid's arrow is proving to be anything but a sure thing.

—By David Kiley in New York

BusinessWeek online For a poll on Viagra and its competitors, go to www.businessweek.com/extras

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X

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Donaldson's Balancing Act

The SEC chairman plans further reforms—mixed with business-friendly flexibility

AT THE WORLD ECONOMIC Forum in January in the Swiss resort of Davos, Securities & Exchange Commission Chairman William H. Donaldson took a break from hobnobbing to moderate a panel on leadership. He listened intently as New York Stock Exchange CEO John A. Thain, Citicorp CEO Charles Prince, and Home Depot Inc. Chairman and CEO Robert L. Nardelli gave pointers. Then the SEC chief offered his own 10 principles of effective leadership. When he finished, Donaldson was startled to find corporate moguls crowding around, pestering him for copies and demanding to know when he would write a book based on his ideas.

Publishers, put those contracts away. Donaldson plans to keep practicing what he preaches at the SEC's Washington headquarters for at least another year. And the 73-year-old Wall Streeter is going to need all the leadership savvy he can muster. Already under heavy fire from Corporate America and some Republicans, Donaldson is walking a fine line. He isn't abandoning his activist agenda so much as balancing his pursuit of further governance and market reforms with

some business-friendly flexibility and regulatory streamlining.

But Donaldson will get in Corporate America's face with a new push to make all forms of executive compensation more transparent, so shareholders can spot when pay outpaces performance. He remains a zealous enforcer. And he still wants to give shareholders more say in board elections. But on that and other issues, he's taking a softer approach that's less likely to rile the boardroom set. And his agenda for 2005 is heavy on items to modernize markets and make existing rules more efficient and effective—a classic Republican deregulatory course that should curry favor with business.

CRUSADING PAST

IT'S A MIX THAT has investor advocates worried. "Streamlining regulation" is often Washington-speak for gutting it," says Barbara Roper, president of the Consumer Federation of America. For now they're trusting that Donaldson won't backslide, based on his track record as a crusader. In his first two years in office, he set a blistering pace as he forced the New York Stock Exchange to overhaul its governance, cleaned up the mutual-fund mess, and threw the book at fraudsters.

ENFORCER
"We're not going to mess with the principles"

The SEC chief insists the commission not retrenching. Consider his most recent concession to business, an offer to retract SEC rules that put teeth in legislation requiring companies to have stringent internal financial controls. Donaldson contends that the SEC always intended to review how the rule worked in practice, and changes, if any, will be modest. "There would be no diminishment at all in shareholder protection," he told *BusinessWeek*. "We're not going to mess with the principles or ask Congress to change" the Sarbanes-Oxley law.

Donaldson also vows to bounce back from the SEC's failed attempt to give institutional investors more clout in board elections. "This is not an attempt on my part to push it under the rug," says Donaldson. "I consider it something

The Going Gets Tough

As SEC Chairman Bill Donaldson begins what could be his final year in office, he faces strong headwinds in keeping his agenda on track. Donaldson ...

» Is pressuring the NYSE to expand electronic trading, but rival markets and his GOP colleagues want to free brokers to trade where they want. Donaldson will probably prevail.

» Will reconsider a Sarbanes-Oxley rule requiring companies to maintain stringent internal financial controls, which Corporate America slams as too onerous. But any changes will probably be modest.

» Thinks executive pay is often out of whack with performance and wants companies to reveal all compensation, including perks and retirement packages. CEOs will resent such rules but are hard-pressed to stop them.

» Intends to sue mutual-fund companies to prevent abusive trading. Fund managers sued to block requiring each have an independent chair. The outcome of the trial starts Apr. 15 is unclear.



nt to be doing, and I'm trying to move it to get it done. As he tries to craft a promise, Donaldson hopes to prod his and legal experts to explore amend-state law to require directors to be elected by a majority rather than a plurality of votes cast.

Corporate America will find that hard to follow. Nor will it take kindly to Donaldson's next quest, to force companies to be clean about all forms of executive pay and incentives, including supplemental retirement packages, perks, and other forms of stealth compensation. Donaldson also wants directors on compensation committees to explain the criteria they use to reward execs. Too many companies, he believes, lavish fat pay packages and perks on their CEOs regardless of performance. Pay experts point to

stiff fines for the fraudsters executives and low lioners his make-myce. There's but wrongdoers inue to face punishment.

» Vows to go back to the drawing board to empower institutional investors to shake up weak corporate boards. But a deal business will swallow remains a tall order.

Hewlett-Packard Co.'s parting kisses to ousted CEO Carleton S. Fiorina—a \$1.5 million bonus for 2004, a poor year for the company, and a \$21 million severance package.

Wall Street, too, is still in the SEC's sights, as Donaldson works to complete a raft of post-Enron reforms. Thorny technical issues have held up approval of new rules aimed at preventing abusive trading in mutual funds. Similar concerns have stymied proposals to curb the use of brokerage fee rebates to pay for products and services unrelated to stock research.

As he pushes more reforms, Donaldson risks creating more friction with business and his fellow Republicans, from the SEC to Congress and the White House. The agency is already battling court challenges to its rules on hedge funds and mutual funds. GOP mutterings about the activist SEC forced President George W. Bush publicly to defend his family's longtime friend—even as Bush reiterated the need for “balance” in regulation.

Donaldson is doing his own balancing act. The SEC is pushing ahead with a plan to make it easier for corporations to register and sell stock, essentially eliminating

the “quiet period” ahead of public offerings and making it easier to raise capital. The agency is working to harmonize international accounting standards and to reduce the regulatory burden on small companies. “It represents a return to the classic agenda that nearly every Republican SEC chairman has pursued,” says Georgetown University law professor Donald C. Langevoort.

GREAT EXPECTATIONS

DONALDSON'S PROMISE to review the internal control rule—the most onerous and costly provision of Sarbanes-Oxley—is also boosting his standing. “This will go a long way to buying Donaldson some peace” with the business community, says John Endean, president of the American Business Conference, an association of midsize growth companies. That goodwill will vanish, though, if the changes are puny. Warns one business lobbyist: “Donaldson's setting himself up for big expectations.”

Raising expectations can be risky. An SEC staff plan to revamp the way stocks are traded lifted rival markets' hopes that the NYSE's barriers to competition would fall. The proposal did prod the exchange to hatch plans to expand its own e-trading.

But the SEC has repeatedly revised its proposal, and Donaldson is reluctant to push the Big Board too hard. “Wisdom here would take changes just so far to avoid the destabilizing danger of fragmented trading,” he says.

At issue: A rule that requires brokers to get the best price for a stock.

One staff approach

would put all electronically displayed orders from every market in one queue to be executed in order, from best price to worst. Donaldson is leery of that. He would require brokers just to look at the best price in each market in deciding where to route orders. Many NYSE rivals and the two other Republicans on the five-member commission want to scrap the best-price rule altogether, arguing that investors should be able to choose where they want to trade.

New market architecture is just one thorny area where Donaldson will need to find compromises in what promises to be his most difficult year yet at the SEC. Those Davos leadership pointers may come in handy. ■

—By Amy Borrus, with Mike McNamee, in Washington

Donaldson risks more friction with business and fellow Republicans

Why the Shorts Have Long Faces

Traders are taking advantage of a new SEC rule to bid up shares of shorted stocks

FOR INVESTORS IN MARTHA Stewart Living Omnimedia Inc., the past two months have been "a good thing," as the domestic diva likes to say. Since early December, the company's shares have shot up over 50% in value. News that Martha will host a new reality-TV show after her release from prison in March helped.

But some market mavens point to another reason: a maneuver by savvy traders to squeeze short-sellers, who borrow stock and sell it in the hope of buying it back for less later because they think the stock is overpriced. Traders put on the squeeze by buying large amounts of Martha Stewart stock to drive up its price and force the shorts to cover their positions at a loss. "Martha has really ripped," notes Stephen Monticelli, president of San Francisco hedge fund Mosaic Investments LLC, who says he locked in a 10% gain in four days.

Monticelli and others are exploiting a new Securities & Exchange Commission regulation designed to crack down on



abusive short-selling. Since early January major stock exchanges have had to publish daily lists of companies for which sellers have failed to deliver sizable amounts of stock to buyers in a timely fashion. That situation often arises when traders engage in what's known in the market as "naked shorting." Normally short-sellers have to borrow stock before they sell it. But sometimes brokers execute a short sale without having a firm arrangement to borrow shares—and then find they can't locate the necessary stock. The new regulation is prompting brokers who can't deliver stock within 13 trading days to close out customers' short positions.

The daily lists signal to other traders that they can pluck profits by mounting a short squeeze in stocks, such as Martha Stewart Living Omnimedia, that are already moving up on positive news. For example, ParkerVision Inc., a Jacksonville (Fla.) maker of wireless devices, has seen its shares soar 62% since it appeared on the list in ear-

ly January. (A ParkerVision spokesman attributes the rise to the Jan. 20 announcement of a potentially breakthrough product.) "If you have a stock with a huge short position list, you just raised a flag for potential manipulation," says Jeffrey Meyerson, vice-president at Crown Financial Group, a Jersey City (N.J.) brokerage firm.

A FUMBLE?

EXECUTIVES OF COMPANIES whose stocks have been penalized by naked shorting are delighted. "This is absolutely a step in the right direction," says Patrick Byrne, chief executive of Overstock.com Inc., a Salt Lake City-based discount e-tailer.

But critics who believe that the shorts play a natural function in the market are angry. They contend that the new SEC regulations increase market volatility and manipulation, particularly among smaller stocks. "The SEC bungled it," says James J. Angel, an associate professor of finance at Georgetown University. "By making it harder to short-sell, it's going to come easier for the pump-and-dump artists to pump shares and then sell them at high prices to unwary investors." Says an SEC official: "It's something we're seeing."

Some short-sellers contend that brokerage firms are already trying to profit from the new rules by slapping extra fees on hard-to-borrow stocks. At Harrisdirect, a division of Chicago-based Harris Bank, investors who want to short Internet travel-offer publisher Travelzoo Inc. must pay an extra fee of \$31.40 a month per 100 shares they want to short. For Cal-Maine Foods Inc., an egg producer that rode the Atkins Diet craze to new heights, the cost of shorting has risen to \$3 a month per 100 shares on the \$10 stock. Harrisdirect chief operating officer, Michael Hogan, says the company is simply passing along the fees it's now being charged by large Wall Street firms.

Harrisdirect officials acknowledge that the fees are putting a damper on short-selling activity. "It has had an impact," says Hogan. "In some of these stocks the economics becomes uninteresting. While that could be a short-term gain for bulls, for the longer term, it could turn out to be a loss for the markets. ■

—By Dean Foust in Atlanta

Squeezing the Shorts

Exchanges must now issue daily lists that are red flags for "naked shorting." Some stocks have taken off after appearing on the list:

COMPANY/TICKER SYMBOL	SHORT RATIO*	STOCK RISE**
Ultimate Electronics ULTEQ	85.6%	20.0%
Martha Stewart Living MSO	39.6	14.5
Cyberonics CYBX	30.0	80.9
ParkerVision PRKR	22.1	62.2
Interchange INCX	16.8	29.4

* Short ratio is percentage of total float.

** Stock rise is percentage of the list.

Data: Merrill Lynch & Co.



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A Persistent Profit Machine

Fourth-quarter earnings surged again—and capital outlays point to more growth

CORPORATE AMERICA IS producing streams of black ink despite tough economic challenges at home and abroad. Profits for the 900 companies on *BusinessWeek's* Corporate Scoreboard rose 25% in the fourth quarter of 2004 from a year earlier on a 14% increase in revenue, well above what the experts were expecting a year ago. For all of 2004, earnings rose even faster, climbing 29% as revenues rose 13%.

But there's even better news buried inside the earnings reports. Many companies are reporting big increases in capital spending, especially in the long-suffering industrial and materials sectors, with a gain of 17% in investment for 2004. That spending is likely to boost jobs and economic growth across the board for the rest of this year. Profits aren't likely to keep growing at the gangbusters pace of recent quarters, but the conditions are right for continued expansion.

Starting with this issue, *BusinessWeek* is taking a fresh approach to the Scoreboard, a popular feature in the magazine since 1973. We're digging into companies' income statements in greater depth, looking for patterns that traditional earnings surveys tend to miss. For instance, this story analyzes capital spending by industry sector—a vital topic as companies bump up their investment in new buildings, equipment, and software.

Also new in these pages is a look at which industries saw the fastest increases in profits per

employee in 2004. The big winners: the materials and information-technology sectors, where profits per worker rose 191% and 81%, respectively, in 2004. Such gains can encourage employers to expand their workforces. We also take a sneak peek at the companies with the highest profit margins in each industry group and a long view of which companies had the greatest cumulative profits—or losses—over the past five years. In that category, the prize goes to Exxon Mobil Corp., with a staggering \$88 billion in earnings, followed by General Electric and Citigroup.

SHAKING OFF TROUBLES

AT THE SAME TIME, we're moving more of the raw data online. The full Scoreboard listings of 900 companies are available in printable and searchable formats at www.businessweek.com/extras (box, page 92).

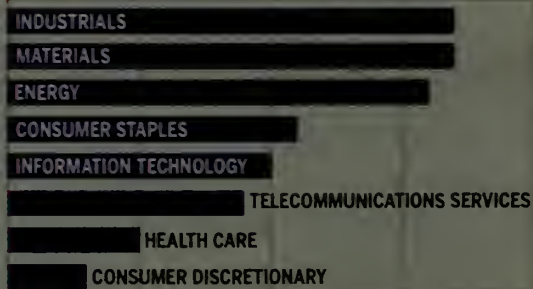
Judging from the numbers, the U.S.



Nuts & Bolts

Companies boosted capital spending

PERCENTAGE CHANGE IN CAPITAL EXPENDITURES*



*AS REPORTED BY 476 COMPANIES, OUT OF 900 TOTAL, FOR THE TWELVE MONTHS ENDED IN THE LAST QUARTER OF 2004, VS. THE SAME PERIOD A YEAR EARLIER
Data: Standard & Poor's Compustat

EASY MONEY

Timber, like other commodity sectors, has thrived

has truly gotten over the recession of 2001 and the subsequent "job-loss" recession and is managing to shake off more recent troubles such as high oil prices, the war in Iraq, higher short-term interest rates, sluggish growth in Europe, and deficits in the federal budget and the trade balance. The fourth quarter of 2004 marked eight straight quarters of double-digit earnings increases. Perhaps more important, 2004 was the first year when corporate profits, as measured by the Scoreboard, were above their boom-time peak of 2000. (For purposes of the Scoreboard, profits are defined as net income from continuing operations before extraordinary items such as natural disasters. Our numbers do include the effect of most asset writedowns.)

Our Scoreboard figure of 25% earnings growth is in line with earnings gains of 407 of the companies on the Standard & Poor's 500-stock index that reported through Feb. 14. According to Bloomberg Financial Markets tabulations, those companies' earnings from continuing operations grew 23.2% in quarter ended November through January compared with a year earlier.

This persistent profit growth is good news not only for the corporate sector but also for the economy as a whole. It's giving executives plenty of cash to invest in the future—without having to go out on limb and borrow. Goldman, Sachs & Co. industry analysts say cash flow is the first choice source for financing capital spending at 90% of the companies they f



last quarter. Companies then used their improved cash flow to step up capital spending. Take Louisiana-Pacific Corp., the Nashville (Tenn.) lumber and plywood company, which has profited from the continuing boom in residential construction, with earnings up 49% last year. It increased its investment in new productive capacity by 78% last year, to \$148 million. In addition, Louisiana-Pacific announced that it was going to build a new wood-panel factory in Clarke County, Ala.

CUTTING-EDGE SECTORS

IN TERMS OF CAPITAL spending, the cutting-edge parts of the economy, like telecommunications, are snapping out of the coma they fell into when the tech bubble burst in 2000-2001. Verizon Communications Inc., the nation's biggest telecommunications company with \$71 billion in revenue, saw its profits more than double last year, to \$7.3 billion. That made it easy for Verizon to afford a 12% boost last year in its already-hefty capital spending budget, to \$13.3 billion. Verizon is sinking the money into projects that should produce higher earnings in the future, such as high-speed network connections. The company extended optical

vs. just 3% of companies where debt is first-choice source.

the paper and forest-products industry typifies the virtuous circle between profits and capital investment. The in-

dustry's profits grew 136% last year, to a collective \$2.4 billion, boosted mainly by higher prices. Lumber prices in 2004 were up 17% compared with the previous year, despite some softening in the

Another Good Year

Energy and financial companies enjoyed strong sales growth, while ExxonMobil repeated as the profits champ

THE TOP 20 IN SALES

	2004 Sales* Millions	Percent Change From 2003	2003 Rank
1 Wal-Mart Stores	\$280,360.0	12%	1
2 ExxonMobil	270,764.0	21	2
3 General Motors	193,452.0	4	3
4 Ford Motor	170,839.0	4	4
5 General Electric	151,300.0	13	5
6 ChevronTexaco	142,897.0	27	6
7 ConocoPhillips	118,719.0	31	8
8 Citigroup	108,276.0	14	7
9 AIG	98,610.0	21	NR
10 IBM	96,503.0	8	9
11 Hewlett-Packard	79,905.0	9	10
12 McKesson	77,842.7	17	12
13 Home Depot	71,407.0	14	13
14 Verizon Communications	71,283.0	6	11
15 Cardinal Health	69,665.1	14	14
16 Bank of America	65,447.0	34	20
17 Altria Group	63,963.0	6	15
18 JPMorgan Chase	56,931.0	28	24
19 Kroger	55,772.0	5	17
20 Valero Energy	54,618.6	44	32

THE TOP 20 IN EARNINGS

	2004 Profits* Millions	Percent Change From 2003	2003 Rank
1 ExxonMobil	\$25,330.0	21%	1
2 Citigroup	17,046.0	-5	2
3 General Electric	16,593.0	6	3
4 Bank of America	14,143.0	31	4
5 ChevronTexaco	13,034.0	77	10
6 Pfizer	11,332.0	596	65
7 AIG	11,229.3	21	NR
8 Microsoft	9,996.0	28	6
9 Wal-Mart Stores	9,825.0	14	7
10 Altria Group	9,420.0	3	5
11 Johnson & Johnson	8,509.0	18	11
12 IBM	8,448.0	11	9
13 ConocoPhillips	8,107.0	77	18
14 Intel	7,516.0	33	17
15 Verizon Communications	7,261.0	110	28
16 Wells Fargo	7,014.0	13	14
17 Procter & Gamble	6,942.0	20	16
18 Merck	5,813.4	-12	13
19 Cisco Systems	5,387.0	24	20
20 Wachovia	5,214.0	23	19

*FOR 12 MONTHS ENDED IN THE LAST QUARTER OF 2004. PROFITS ARE NET INCOME FROM CONTINUING OPERATIONS BEFORE EXTRAORDINARY ITEMS. NR=NOT RANKED
Data: Standard & Poor's Compustat

fibers to about 1 million homes last year and aims to reach an additional 2 million homes this year. That investment is entirely aside from Verizon's Valentine's Day announcement of an agreement to buy MCI Inc. for \$6.7 billion, which doesn't involve any fresh spending on buildings, equipment, or software.

MATERIALS: SUDDENLY SEXY

ADD UP THE NUMBERS, and capital spending by Corporate Scoreboard companies grew 18% for the quarter and 9% for the year. That's based on capital spending reported by 476 companies out of 900 total. This year looks good, too, in spite of the Dec. 31, 2004, expiration of a provision that let companies immediately expense 30% of the cost of equipment and software. Blue Chip Economic Indicators says economists are looking for a 10% gain in capital expenditure in 2005.

To make good money in 2004, it sure helped to be born an oil company. The price of oil averaged over \$40 a barrel—the highest yearly average ever. Exxon-Mobil topped all companies with \$25.3 billion in profits, a 21% increase over 2003. ChevronTexaco Corp. and ConocoPhillips also cracked the list of top 15 earners with identical 77% increases in annual profits. Those companies led the energy sector as a whole to a \$22 billion increase in annual profits compared with the previous year, the most of any sector.

Similarly, the strong 136% rise in profits in paper and forest products evinced a wider trend in the suddenly hot materials sector, which includes chemicals,

Last year's profits exceeded the boom-time peak in 2000

metals and mining, construction materials. Propelled in part by demand from China, the sector experienced a combination of higher prices and higher profits. Altogether, total earnings for materials companies by \$14 billion.

At the other extreme, the sectors whose profits fell in 2004. Profits fell \$5.5

billion in telecom services, dragged down by AT&T's \$6.1 billion loss. Profits declined \$4.8 billion in transportation, the result of more red ink from airlines, where higher jet-fuel prices inflicted much of the pain. UAL Corp. alone lost \$1.6 billion.

Energy up, telecom and airlines down. The pattern feels familiar. Besides Exxon-Mobil, ChevronTexaco also made the

list of the companies with the highest cumulative earnings over the past five years. The top five-year earners also included three tech companies, three drugmakers, and three financial giants. UAL was among the bottom five, with \$9.5 billion in accumulated losses. Lucent Technologies Inc., the network-gear maker, fared even worse, with five-year losses of \$24.1 billion.

While those businesses rode the tide of their industries, the intriguing companies are those that produced stellar results in excess of the rest of their industry group. Harley-Davidson Inc. rode the popularity of its "hogs" to the highest profit margins in the automobiles and components sector among Scoreboard companies. Equifax Inc., the credit-reporting service, came out on top in commercial services and supplies. EBay Inc. trounced other retailers—no surprise, given the low operating cost and high popularity of its online shopping business. Medtronic Inc., which sells pacemakers, had the highest profit margin in health-care equipment and services. And Coach Inc. known for its fancy leather goods, had the highest margins in consumer durable and apparel.

What's next for corporat



Profits by Industry

Energy, materials, and information technology had a strong 2004, while telecom lagged

Workers Contribute More Profits

	Dollars of profit per employee in 2004*	percent change from 2003
Materials	\$18,149	191%
Information Technology	28,056	81
Energy	117,507	44
Utilities	47,786	38
Consumer Discretionary	9,234	29
Health Care	39,489	22
Industrials	9,447	15
Financials	72,450	8
Consumer Staples	13,102	6
Telecommunication Services	15,861	-31

* BASED ON LATEST AVAILABLE EMPLOYMENT DATA
Data: Standard & Poor's Compustat

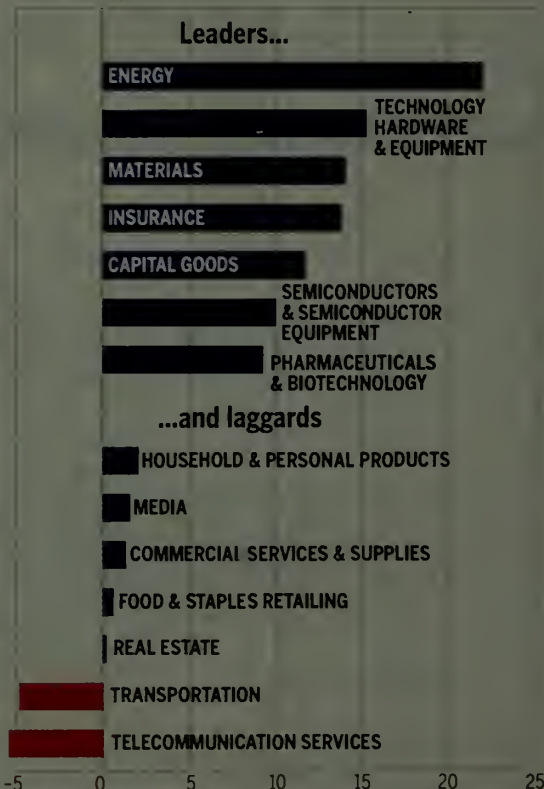
Profit Growth Begins to Sag



* FOUR QUARTER AVERAGE OVER FOUR QUARTERS A YEAR EARLIER, SMOOTHED.
BASED ON BUSINESSWEEK'S QUARTERLY SCOREBOARD OF 900 COMPANIES.
Data: Standard & Poor's Compustat

Making the Big Bucks

ONE-YEAR CHANGE IN TOTAL INDUSTRY PROFITS OR LOSSES
BILLIONS OF DOLLARS*



* NET INCOME FROM CONTINUING OPERATIONS BEFORE EXTRAORDINARY ITEMS FOR THE 12 MONTHS ENDED IN THE LAST QUARTER OF 2004, VS. A YEAR EARLIER.
Data: Standard & Poor's Compustat

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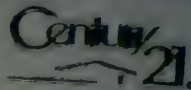
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profits? Thomson First Call says that, according to its survey, industry analysts are expecting earnings growth for the S&P 500 companies to slow from its 2004 pace, fluctuating between 8% and 12% each quarter and totaling 9.7% for the year. On the other hand, the experts have been wrong before: In January, 2004, those same analysts were forecasting earnings growth of 14.2% for the fourth quarter. The growth rate now looks more likely to come in at 20%, using First Call's earnings measure.

Will we see strong growth in 2005? The answer comes down in part to whether the profit surge to date emboldens executives to continue expanding.

Rising profits give companies incentive to hire more workers

There was a surge last year in the dollars of profits earned per employee. In the materials sector, which includes steel and other in-demand commodities, profits per employee nearly tripled. Information technology saw an 81% increase.

Those rising profits do two things: They give companies the incentive to hire more workers, since their existing employees are paying off so handsomely. They also give executives confidence that investment in equipment will be money well spent. And continued strength in capital spending is what it will take to keep this profit cycle rolling forward. ■

—By Peter Coy in New York

Online Scoreboard

Full results for all 900 companies in the Corporate Scoreboard are available at www.businessweek.com/extras. The tables contain all the data that has past have appeared in the pages of this magazine, including sales, profits, profit margins, return on common equity, earnings per share, and price-earnings ratios. The tables can be viewed and printed as Adobe PDF documents in format of magazine pages. Alternatively they are available in a searchable format that allows the reader to rank companies by clicking on column headings. For example, it's possible to select media companies and rank them from the highest price-earnings ratio to the lowest.

BusinessWeek online



A Closer Look at Performance

Companies that led their industry groups in profit margins ranged from Harley-Davidson and 3M to Gillette and Oracle

The Long View

WINNERS

Companies with highest cumulative profits, 2000-2004*

	Billions
ExxonMobil	\$88.1
General Electric	74.2
Citigroup	73.8
Bank of America	48.5
Altria Group	46.7
Microsoft	42.0
Wal-Mart Stores	38.7
AIG	38.2
IBM	37.4
Pfizer	33.2
ChevronTexaco	33.2
SBC Communications	33.2
Johnson & Johnson	32.9
Merck	32.8

LOSERS

Companies with the biggest cumulative losses, 2000-04*

	Billions
Corning	-\$9.4
UAL	-9.5
Verisign	-21.5
Lucent Technologies	-24.1
Time Warner	-40.2

*Cumulative net income from continuing operations before extraordinary items, five years ended in the last quarter of 2004.
Data: Standard & Poor's Compustat

The Margin Leaders

Even poorly performing industry groups such as transportation produced winners

Industry Group	Company with the highest profit margin in 2004	Company profit margin 2004*	Industry Group profit margin 2004*
Automobiles & Components	Harley-Davidson	16.7%	1.9%
Banks	Doral Financial	47.9	21.1
Capital Goods	3M	14.9	6.9
Commercial Services & Supplies	Equifax	18.6	5.5
Consumer Durables & Apparel	Coach	21.3	6.6
Diversified Financials	SLM	43.8	13.9
Energy	Kinder Morgan	45.4	8.4
Food & Staples Retailing	Walgreen	3.7	2.4
Food Beverage & Tobacco	UST	29.3	7.9
Health-Care Equipment & Services	Medtronic	21.8	4.5
Hotels Restaurants & Leisure	Carnival	19.1	9.1
Household & Personal Products	Gillette	16.1	11.7
Insurance	Ambac Financial Group	51.7	9.5
Materials	Sigma-Aldrich	16.5	5.1
Media	Gannett	17.8	7.3
Pharmaceuticals & Biotechnology	Gilead Sciences	33.9	16.7
Real Estate	Thornburg Mortgage	24.5	10.8
Retailing	eBay	23.8	4.4
Semiconductors & Equipment	Linear Technology	41.1	14.3
Software & Services	Oracle	27.9	12.8
Technology Hardware & Equipment	Qualcomm	36.1	6.1
Telecommunication Services	BellSouth	16.9	4.5
Transportation	Norfolk Southern	12.6	0.0
Utilities	Equitable Resources	23.5	6.9

*NET INCOME FROM CONTINUING OPERATIONS BEFORE EXTRAORDINARY ITEMS, DIVIDED BY SALES, FOR THE 12 MONTHS ENDED IN THE LAST QUARTER OF 2004
Data: Standard & Poor's Compustat

The Education of Lindsey Graham

a senator, the former House GOP firebrand is embracing compromise



BACK IN THE EARLY DAYS of the Republican Revolution, Lindsey O. Graham saw himself as the tip of the sword. In 1997 the young representative from South Carolina led a revolt against House Speaker Newt Gingrich, for, among other things, being too quick to cut a budget deal with President Bill Clinton. The coup failed, but Graham survived to scold Clinton. In 1998 he helped manage the defense of Clinton's impeachment. That sealed Graham's reputation as a conservative firebrand and helped him win the Senate seat held for a half-century by Strom Thurmond. As a freshman senator, he's still shaking up the status quo by trying to make a name for himself as a serious legislator. "The older I get, the more pressure I feel to have my time mean something," Graham says. "It would be very nice if Lindsey Graham, impeachment boy, could also be

thought of as a problem solver."

So Graham is reaching across the aisle. He has become a key player in the effort to find a bipartisan resolution to the Great Social Security Debate. Soon, he'll propose a safety net for low- and middle-income workers who opt for personal accounts. And his willingness to partially fund the accounts with payroll tax hikes on those making more than \$90,000 has generated considerable controversy. Graham is also sponsoring leg-

Maverick on the Right

Where Graham is breaking rank

AMONG FRIENDS

Graham (second from right) remains a staunch social conservative

islation with Senator Hillary Clinton (D-N.Y.) to boost benefits for reservists and the National Guard. And he is working with Democrats such as California Senator Dianne Feinstein to protect consumers' rights in the face of a GOP push to limit medical and class-action lawsuits. "He's deeply conservative, but he is also willing to defy orthodoxy to get things done," says Marshall Wittmann, a former adviser to Senator John McCain (R-Ariz.).

VEERING TO THE CENTER

GRAHAM REMAINS reliably conservative on social issues. But his combination of independence and pragmatism makes him an anomaly in the Senate, which in recent years has become much like the hotbed of bubbling partisanship that he and his fellow revolutionaries created in the House. "He's willing to make political compromises rather than ideological compromises," says Blease Graham, a political scientist at the University of South Carolina (and no relation to the senator). "In politics, sometimes you have to make temporary pacts with the devil when the issue demands it."

Still, Graham's plan to boost Social Security payroll taxes for high-wage workers has him veering far from GOP orthodoxy. And he's not shy about making his case. In December, Graham took his pitch to the conservative Heritage Foundation, where his talk of tax hikes was greeted with lots of grumbling. He also is bluntly warning CEOs that new payroll taxes will be part of any Social Security deal.

To reach an accord, Graham is working with about a half-dozen senators, including Finance Committee Chairman Chuck Grassley (R-Iowa) and senior panel Democrat Max Baucus of Montana. But despite their bipartisan intentions, the participants have not even been able to settle on a description of the problem, much less a solution.

Graham says he learned about Social Security as a young man. His parents, who owned a combination liquor store, pool

SOCIAL SECURITY He was an early backer of private accounts but would tax wages above \$90,000—heresy in the GOP.

LEGAL REFORM A former trial lawyer, Graham has been reluctant to back the sharp limits on medical and other lawsuits that business would like.

IRAQ He is an Air Force Reserves judge, a strong backer of the armed services, and supports the Iraq war. But that hasn't stopped him from being sharply critical of the abuse of Iraqi detainees at Abu Ghraib.

hall, and restaurant in Seneca, S.C., died within a year of each other when Graham was in his early 20s and his sister was just 13. Graham, now 49, says that without the roughly \$600 a month his sister got in survivor's benefits, "we'd have been sucking wind." To preserve the program, he says, both President George W. Bush and lawmakers should call a truce. "Just park your political differences for the time being," Graham says. "See if you can solve a problem or two."

Not surprisingly, any talk of compromise has some economic conservatives fuming. In a Web posting for the conservative journal *Human Events*, former GOP Vice-Presidential candidate Jack Kemp says Graham and others "are draining personal accounts of their vitality, jeopardizing Social Security reform, and ultimately endangering the Republican congressional majority."

TRIAL BALLOON?

GRAHAM DISMISSES such criticism as "just part of politics." And while the White House isn't thrilled with his call for tax hikes, he may not be exactly freelancing. The Administration has been adamant about not raising payroll tax rates but has said nothing about taxing wages above \$90,000. "The White House is not at all upset," speculates AARP lobbyist John Rother. "He has at least their tacit support."

Still, the senator is willing to take on the Administration on other issues. For instance, Graham, who serves as an Air Force Reserves judge, was furious at the abuse of Iraqi detainees at Abu Ghraib prison—and he didn't mind saying so. "It was the biggest breakdown of command I've ever seen in my 20 years as a military lawyer," Graham charged during congressional hearings last year.

His ability to get out front on hot issues such as Abu Ghraib, tort reform, and Social Security has raised his profile far higher than that of a typical first-term senator. That, inevitably, has led to talk about an eventual run for the Presidency. For now, Graham laughs off such speculation, and a candidacy in 2008 seems unlikely. But helping to shape a deal on Social Security would position Graham as one of the few young pragmatists in an increasingly ideological Senate. ■

—By Howard Gleckman, with Richard S. Dunham and Lorraine Woellert, in Washington

BusinessWeek online For a Q&A with Senator Graham, go to www.businessweek.com/extras

CONCEPT CAR
Performance is key to the IS 350



Sexy Enough To Seduce Europe

Lexus will amp up its cars' pizzazz and ditch the understated styling

SINCE TOYOTA MOTOR Corp.'s Lexus division first broke into the U.S. luxury market back in 1989, its recipe for success has been plain and simple: Lexus' vehicles are understated outside and comfy and quiet inside. And its dealers bend over backwards for customers. While long-established names such as BMW, Mercedes-Benz, Audi, and Cadillac battled each other by adding more horsepower and by pushing the limits of styling, Lexus made conservatism its virtue. Americans loved it, buying enough posh cars and SUVs to make Lexus the best-selling luxury brand in the U.S.

But Lexus' lead isn't all that it appears. More than half of the vehicles it sells these days are SUVs, at a time when demand for big SUVs is slowing. Factor that out, and Lexus actually ranks fifth in luxury passenger-car sales in the U.S. Most ominously, an increasing number of luxury-car shoppers are voting for speed and handling over a soft ride. Says Eric Noble, president of Car Lab, an Orange

(Calif.) consulting firm: "Boomers have a taste for cushy the way the younger generation does."

Lexus, in short, needs to take on German car companies. That explains why it's about to shake things up. On Mar. 3 at the Geneva Auto Show, BMW's Swiss backyard—Lexus will show off its new IS 250 and 350, luxury performance cars styled to look as if they were molded from a single piece of metal. The IS 350 and the just-launched, aerodynamic GS 430 sedan are the products of a push to make Lexuses faster—and faster-looking. Lexus boasts that these cars' performance will rival that of BMW's Ultimate Driving Machines. They're also going to jack up prices. The IS 350 will cost a few thousand more than its predecessor. The \$43,000 GS 300 and \$51,000 GS 450 are about \$2,000

BMW 3 Series
A rival is out to

expensive. An exotic sports car with a tag of over \$100,000 may even be a way.

coincidentally, Mar. 3 is two days before BMW plans to unveil the latest version of its 3 Series sedan. Lexus executives vow to steal even more BMW and Mercedes owners in the U.S. and eventually challenge those brands in Europe, where Lexus barely registers today. Says Group Vice-President Dennis E. Clements: "It is our intention globally to become the preeminent luxury car."

Can he pull it off? It's unwise to bet against Toyota. The parent company's market share is growing in Europe and the U.S. Meanwhile, Lexus widened its sales lead over BMW last year, to almost 30,000 vehicles. Its dealers routinely rank first in J.D. Power & Associates' customer-satisfaction survey. And Lexus brand beats all other luxury names when it comes to consumer aspiration, according to California firm Strategic Vision Inc.

NOT AS A TOMB

PIZZAZZ HAS never been Toyota's selling point. The bulbous SC 430 convertible is the closest thing to a styling statement from Lexus; it sells a modestly successful 10,000 cars a year. Toyota backed with its attempts to draw sports fans with the MR2 Spyder, which hit the market in 2000, and the Supra sports car before that. The Supra no longer sells in the U.S., and the MR2 will make its exit this year. "Lexus equity is tied up in cars that are tomb-quiet, not in [their] performance," says Daniel Gorrell, a manager at Strategic Vision.

Lexus cars were styled cautiously on purpose. Executives saw comfort and reliability, not fashion, as their selling point. In some cases, the cars were created by Toyota engineers, who operated without a styling motif to make the cars look as if they came from the same family. But two years ago, Toyota built a Lexus engineering and design center in Nagoya, Japan. The brand now has several hundred stylists and engineers feeding ideas from satellite studios in the French city of Nice and in Southern California.

That new design effort is key to the emerging European strategy. Make no mistake: Selling cars in Europe—especially to Germans—will be Lexus' biggest challenge. The brand sold just 25,000 cars there last year and has a target of 65,000 by the end of the decade. Compare that with BMW's sales of 573,000 cars in Western Europe, up 11% from 2003.

It doesn't help that up till now Lexus has not offered high-performance diesel engines. This will change with the new IS model, which comes with an optional 2.2-liter diesel. But Lexus is relying on its cutting-edge hybrid gas-electric technology to deliver a performance boost. It remains to be seen if diesel-loving Europeans will take to the new technology. Rivals aren't too worried for now. "We are taking them seriously," says BMW Chairman Helmut Panke. "But right now, we have one global competitor, and it's Mercedes."

Lexus has much more at stake in the U.S. In passenger-car sales it trails BMW, Mercedes, Cadillac, and even Honda Motor Co.'s Acura division. And Lexus has performance issues. The current IS 300 struck out against the BMW 3 series and other cars selling for \$30,000 to \$40,000

Lexus sales in Europe are only 5% of BMW's

because it was smaller and, in some cases, underpowered. Its V-6 engine kicks out 215 horsepower, but rivals such as the Cadillac CTS, Infiniti G35, and the 3 series all sell optional engines with at least 225 hp. The new cars promise to pack much more punch: Lexus says the V-6 in the new IS 350 will have well over 300

hp, and the new GS 300 and GS 430 have at least 245 hp.

THE STRETCH MODEL

CLEMENTS SAYS Lexus isn't trying to become BMW. The new cars will offer all-wheel drive, and craftsmanship will still be a priority. (Even in lower-priced Lexus vehicles, all wood in the interior comes from the same tree, so the grain matches.) Still, the styling makeover will be even more pronounced when the new flagship LS 430 sedan hits the market in two years. The most expensive LS 430 now sells for \$74,000, but Lexus plans a stretched, \$100,000 version to compete with Mercedes' tony S500 and S600 sedans. Dealers have been told to expect a production version of a Formula One-inspired sports car near the same price.

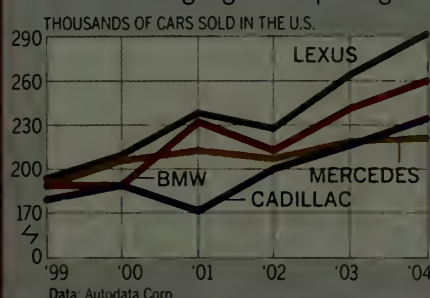
Can Lexus sell cars for six figures? If they deliver the performance that Lexus is promising, surveys indicate buyers will pony up the additional cash. "The Japanese have always played it safe," says dealer Kenneth Meade of Meade Lexus in Lakeside, Mich. "But if you want to run with Mercedes and BMW, you have to have style and performance." For Lexus, this is no time to get comfortable. ■

—By David Welch in Detroit

BusinessWeek online For a slide show on the new Lexus vehicles, go to www.businessweek.com/extras

THE LUXURY CAR CREME DE LA CREME

Lexus has built a sizable U.S. lead; now it's making a grab for prestige



LEXUS
2006 GS 430
Aerodynamic
—and faster



Personal Business Travel



MOVEABLE FEAST
A floating market
boats on the
Mekong River

Dollar-Friendly Destinations

Vietnam

One of Asia's most diverse travel locales—and getting there is easier than ever. **BY SHERIDAN PRASSO**

THERE'S GROWING excitement about Vietnam these days: The economy is booming, the weather is warm, the history is rich, and the country is eager to lure Americans. Tourists, it seems, are just as eager to go to one of Asia's most diverse travel destinations. "I have to go before it gets touristy," says Melissa Blosssey, a 42-year-old New Yorker flying to Ho Chi Minh City on a recently launched United Express flight, the first by a U.S. carrier since the Vietnam War. "It seems like a beautiful place, and I've always heard great things about the people and shopping. The cuisine is supposed to be incredible. Plus, you get good value for the dollar." She's right on the money. The food and shopping are fantastic. And the dollar, which has risen 3% over the past six months against the dong, definitely goes a long way. A silk jacket custom-made by a tailor on the fashionable Dong Khoi Street in Ho Chi Minh City, formerly called Saigon, costs all of \$29. Just \$40 will buy you dinner for two, including wine, at the top-rated restaurant, the Mandarin, and a room at the restored luxury Car-

avelle Hotel can be had for \$97 via discount hotel Web sites. Some will remember the Caravelle as the setting for the "Five O'Clock Follies" news conferences during the Vietnam War.

Vietnam isn't just cheap. Tourism officials like to promote it, in contrast to Bali or Thailand, as a safe haven from terrorist attacks. The country, located on the Pacific Ocean side of Asia, was also unaffected by the December tsunami disaster in the Indian Ocean. Don't be deterred by re-

ports of bird flu either: It is largely limited to rural areas and farms.

The resumption of the first direct flights from the U.S. to Vietnam since the war is making it easier for Americans to get there. The daily B-747, originating at Washington Dulles International Airport and passing through San Francisco and Hong Kong to Ho Chi Minh City, has been so popular since its Dec. 9 launch that discount round-trip economy fares in the \$1,000-to-\$1,200 range have been selling out quickly. American Airlines and Continental plan to follow suit.

Although many Americans are drawn to Vietnam because of their interest in the war, the country has a rich and varied culture. A good way to sample all the facets is to start in the former capital of South Vietnam and work north. Ho Chi Minh City is

SCOOTER CHIC
Ho Chi Minh City is Vietnam's business center





RICH HISTORY
Montagnard women in Sapa; a guide at the Cu Chi tunnels near Ho Chi Minh City

while trip for those who want to understand the Vietnamese perspective.

The province of Tay Ninh, a day trip northwest by tour bus from Ho Chi Minh City, is home to the Cao Dai religion, which reveres as saints Jesus Christ, Buddha, Victor Hugo, and Joan of Arc, among others. Its cathedral, with its all-seeing eye similar to that on a dollar bill, draws hundreds of worshippers each week. Southern Vietnam also offers Mekong River excursions, where tourists can see floating markets and visit villages that make baskets and lacquerware.

CHINA BEACH REVISITED

A SHORT \$49 FLIGHT from Ho Chi Minh City takes you to Danang, close to the gorgeous China Beach made famous in *Apocalypse Now* and the 1990s TV series. The number of Americans staying at the five-star Furama Resort Danang has gone from a handful of mostly Vietnam vets five years ago to about a third of its 83,000 guests in 2004, says manager Paul Stoll. From the hotel grounds, you can see the former U.S. military base, with its crumbling cement walls and lookout towers. The USO China Beach, a stage area to entertain troops, was a couple hundred yards north.

Danang is a convenient point from which to hire a driver and

helicopters sit forlornly outside, and jars of preserved fetuses deformed by Agent Orange are on display inside. It's a sobering but worth-

explore the UNESCO-designated Heritage Road. It goes through the Mountains, the five hillocks that witness scene of heavy fighting during the Vietnam War. Hoi An, an ancient port founded by the Portuguese, where century-old Chinese traders' houses have been converted to hotels and where oil painters' studios abound on the narrow streets; and the ancient imperial capital grace emperors' palaces and tombs. It boasts coral reefs for scuba diving, deep-sea fishing, as do the more so beach resorts of Nha Trang.

The capital, Hanoi, two hours by train from Ho Chi Minh City and an hour by bus from Danang, is one of the most European cities in Asia. It's partly the result of the colonial buildings dating back to the 1920s and '30s, when Vietnam was a French colony. Hanoi is filled with tranquil lake greenery that stand in serene contrast to the city's roaring motorbike traffic. The Old Quarter, north and west of the city, has richly atmospheric streets lined with shops selling crafts, silk clothing, jewelry, and art. You can bargain for prices by as much as 30%.

Hanoi also has become a draw for foodies. In addition to the traditional light, healthy fare at restaurants such as Emperor and Wild Rice, the city's chef Bobby Chinn's hip nouveau eatery at the foot of Hoan Kiem Lake, featuring fabulous fusion cuisine. His menu includes blackened barramundi on banana blossoms. Even his meals, which are more expensive in Vietnam, cost less than \$50 for two.

If you're interested in Vietnam's ethnic diversity, go to the home of the Montagnard minority people living on the mountainous border with Laos. An overnight train ride from Hanoi to Sapa is largely rural. The hill tribes, which include the Tay and H'mong, wear colorful clothing and silver buttons and jewelry which they hawk to tourists.

Excursions outside Hanoi should include Halong Bay, with its limestone rock formations, coves, and lagoons plied by wooden fishing vessels along the Gulf of Tonkin. A UNESCO World Heritage site, Ha Long Bay means "dragon in the sea."

With so much to see and do with flying there getting easier for Americans, the saying about Vietnam, that "it's not a war, it's a country," rings truer than ever. ■

Hanoi, the capital city, is a draw for foodies

the commercial center of the country, sort of the New York of Vietnam, compared with the capital city of Hanoi, which is akin to Washington.

Those in search of war history will find it in places such as the Rex Hotel. What was its rooftop U.S. Officers' Club in the 1960s and '70s is now a restaurant and bar offering fine views of the city. Also on the must-do list is a guided tour of the Cu Chi tunnels, where the Viet Cong built an extensive underground network. At the War Remnants Museum, formerly the Museum of American War Crimes until Vietnam and the U.S. normalized relations in 1995, captured American Huey

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visit to South Africa can seem daunting for most Americans—and not only because flying from New York to Johannesburg takes at least 16 hours. South Africa's crime rate is one of the highest in the world. And the country is big, with more than 1,500 miles separating the two unvisited regions, the Cape Town area in the south and the savannas near the Mozambique border where Kruger and numerous other game parks are located. That's why many opt for package tours that include a few days at a game park and a few days in Cape Town. Those can run \$1,000 and up with airfare. But as my nine-year-old son and I discovered on a 10-day visit last year, a do-it-yourself South African vacation can be more rewarding than a package deal—and less expensive. Making arrangements was hard: Most leading tourist

South Africa

Doing your own way can be a lot more rewarding than a package tour. **BY CAROL MATLACK**

destinations have Web sites, and everyone speaks English. While the national currency, the rand, has strengthened against the dollar over the past few years, prices are still low. Not as low, perhaps, as Kenya. But South Africa, with its reliable domestic air service and well-maintained highways, is one of the few places in sub-Saharan Africa where traveling on your own is feasible.

We started in Cape Town, a place of unmatched natural beauty. The city spreads along the shores of a wide bay, framed by three mountain peaks. The most dramatic is Table Mountain, whose flat top is often draped with a cloud "tablecloth." We picked up a car at the airport, where all the major rental agencies have outlets and will accept U.S. driver's licenses. We headed to the Holiday Inn at the foot of Table Mountain. Rooms there cost about \$110 a night, including taxes, and kids' meals are free.



TABLE MOUNTAIN
A must-see destination in Cape Town

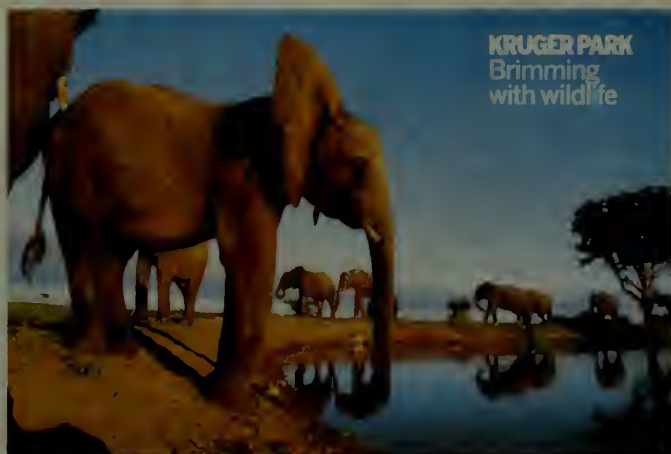
The hotel was our base for day trips. It also provided me with one of the most moving experiences of the vacation. My mother was South African, and I had visited in the 1970s and 1980s. But on our first morning, I saw a scene that would have been unthinkable during those apartheid days: interracial couples chatting over breakfast and a multiracial group holding a business meeting in a conference room. I burst into tears.

STORIED PRISON

THERE WERE OTHER welcome surprises. Cape Town's once-seedy harbor has been redeveloped into the convivial Victoria & Alfred Waterfront, including outdoor restaurants, shops, and a marina. From there we caught a boat to the infamous Robben Island prison, where Nelson Mandela was held for nearly 20 years. The prison is now a museum and former inmates lead tours, pointing out the quarry where Mandela and other political prisoners were forced to work and the communal cells where they lived.

Another day we drove to Cape Point, near the southernmost tip of Africa, where the cold, steely blue Atlantic meets the warmer, calmer waters of the Indian Ocean. The cable-car ride up Table Mountain was another highlight.

From Cape Town, we flew to Johannes-



KRUGER PARK
Brimming with wildlife

burg and rented a car for the four-hour drive to Kruger, a park about the size of Massachusetts. Kruger brims with so much wildlife that a professional guide seemed superfluous. Indeed, half the fun for my son was spotting the fresh droppings that alerted us to an animal's presence. During three days in the park, we saw everything from lions, rhinos, and giraffes to herds of impalas and flocks of weaver birds, so named because they weave nests that hang pendantlike from trees. The park's roads are well-marked, and locations of recent animal sightings are posted at ranger stations. As long as you stay in your car, you're free to explore at will.

We stayed at Lower Sabie, one of several camps in the park. Each camp typically includes a restaurant, store, and swimming pool. Our air-conditioned bungalow, which included a covered porch with kitchenette and dining table, cost \$79 a night. In the bungalow next to ours was a farm family from the KwaZulu-Natal region near Swaziland, who invited us over one night for a *braai*, a barbecue of steak and sausages. Over a bottle of South African wine,

SAVANNA STARS

Most tours include stays in a game park and in Cape Town

they related how AIDS has hit even their remote town, killing several of their farmhands.

Such conversations are a reminder that South Africa remains a troubled country. Tourist spots are well-guarded, but the sprawling all-black settlements are dangerous. To see them, book a "township tour," which often includes a visit to a local beer hall, or *shebeen*.

Wouldn't a package tour be easier?

Maybe. But if you're on a tour bus, you'll miss scenes such as the one we saw the morning we left Kruger. Instead of the main highway, we took a road through a valley with hundreds of huts scattered across green hillsides. A thunderstorm had just passed, and a rainbow hovered in the valley as people came outside and began their chores, hanging laundry and tending gardens. At moments like that, do-it-yourself travel really pays. ■



British Columbia

In the beautiful Okanagan Valley, it's Napa without the crowds. **BY AMY CORTESE**

IMAGINE CALIFORNIA'S NAPA Valley 30 years ago, without the commercial trappings, grandiose wineries, and snaking traffic. Plop a sparkling lake surrounded by snow-capped peaks in the center, and the pastoral tableau pretty much captures British Columbia's main grape-growing region, the Okanagan Valley. On the same latitude as Germany's famous Rhine Valley, the Okanagan Valley is a semi-arid desert with the hot days and cool nights essential to a great wine-producing climate.

There, a growing number of wineries (58 at last count) are turning out highly rated products at prices averaging just \$20 a bottle. If you want to sample the goods, from aromatic whites to full-bodied reds, your best bet is to visit the area. Since the vineyards are typically small, family-run affairs, output is minimal, and most of the bottles are sold locally.

Luckily, the U.S. dollar is still about 20% higher than its Canadian counterpart, making the area a relative bargain. Getting to Okanagan involves a four- to six-hour drive or short plane hop from Vancouver or Seattle. The valley is 126 miles long, so you can tour it easily in a weekend. The well-situated town of Kelowna offers upscale lodging, such as the Manteo Resort Waterfront Hotel & Villas along 69-mile Okanagan Lake. You can find more laid-back accommo-

dations in nearby Naramata.

Stop by the British Columbia Wine Information Center in Penticton for a map, and you're ready to get started. Penticton is the place to see—and taste—the valley in the least amount of time. Climb along Naramata Road are gems such as La Frenz, Kettle Valley, and Penticton Grove. Across the lake to the west is

Sission Hill Family Winery, known for its lush Bordeaux-style reds. The winery offers lake views, too, and al fresco dining at the Terrace (May-October).

The southernmost part of the valley, named Osoyoos after the native tribe, is the most arid, and heat-lo-

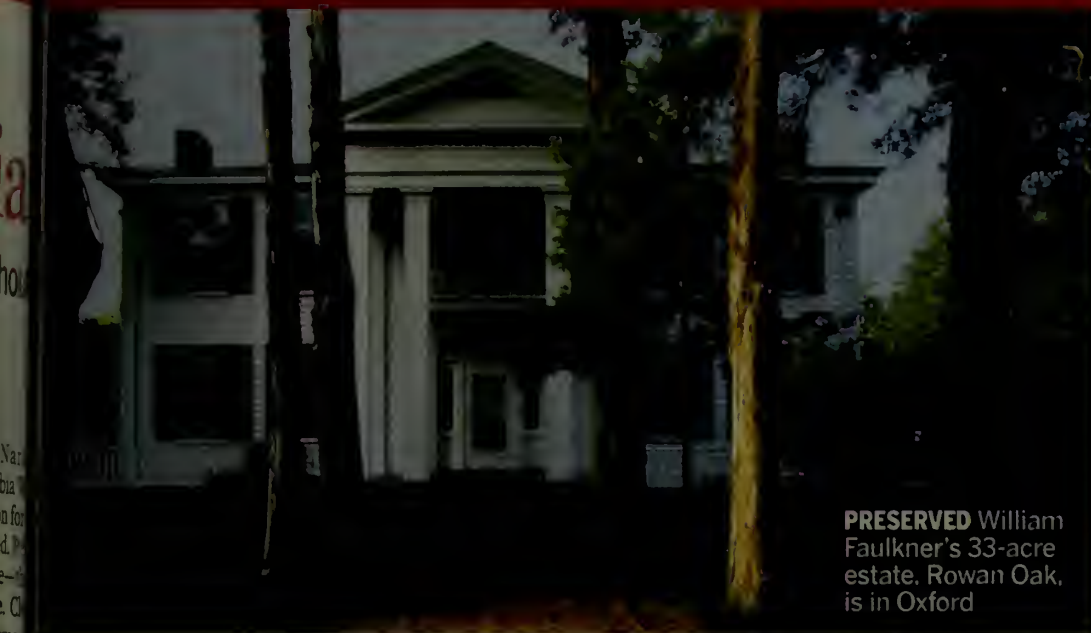
varietals such as cabernet and merlot flourish there. A notable stop is the Osoyoos-owned Nk'Mip Cellars. To the north is Burrowing Owl Estate Winery, which operates the Sonoma-style restaurant, where you can sample the estate's coveted "library" wines, no longer sold to the public.

The northernmost reaches are home to cool-weather-loving grapes such as pinot noir and Germanic whites such as Riesling. That area also is ideal for producing Okanagan's famed ice wines, made by leaving grapes left on the vines to freeze.

You might time your visit to coincide with one of the many festivals (thewinefestival.com). But if you want to stock up on local wine, cellar, locals suggest visiting between May and June, when many wineries sell their inventories. ■



PANORAMA
Mission
vineyard



PRESERVED William Faulkner's 33-acre estate, Rowan Oak, is in Oxford



you'll find Greenville, which residents claim has produced more writers per square foot than any city its

Mississippi

erary tour through the state evokes the voices of Welty, Williams, and more. **BY KATE MURPHY**

ASK FOLKS IN MISSISSIPPI for directions, and they'll not only take you where you want to go, they'll tell you a good story on the way. Spinning yarns is sport which might explain why so many state's sons and daughters went on to become renowned authors. William Faulkner, Walker Percy, Eudora Welty, Tennessee Williams were all Mississippinatives. Touring the state, you can see their homes and papers as well as experience the quirky Southern charm that inspired their work.

The capital, Jackson, is a good place to start. Spring is an especially fine time to visit, with the Japanese magnolias in bloom first, followed by daffodils, dogwood, and azalea. You'll see all of them in Eudora Welty's garden at 1119 Pinehurst Road (ndah.state.ms.us/welty/). Her garden was recently restored to the way it looked from 1925 to 1945, when Welty worked as a writer. Open Wednesdays from 10 a.m. to 2 p.m., March through October, it features 13 varieties of camellias and a rose-tangled arbor.

Welty's adjacent Tudor-style home will not be open to the public until renovations are finished in 2006, but you can still

walk the perimeter and imagine the author, who died in 2001, gazing out her bedroom window while writing *The Optimist's Daughter* and the short story "Death of a Traveling Salesman." Other Welty-related sites around the city include the George Street Grocery, which is mentioned in her work, as well as the cemetery where she is buried. At the William F. Winter Archives & History Building, you can peruse Welty's photographs and papers.

WHERE "BLANCHE" LIVED

AUTHOR WILLIE MORRIS grew up less than an hour's drive northwest of Jackson, in Yazoo City (yazoo.org). Morris warmly portrayed his boyhood in this sleepy riverside town in *North Toward Home* and *My Dog Skip*. You can pass his modest, single-story childhood abode at 615 Grand Avenue. His grave is less than two miles away, in Glenwood Cemetery.

Drive 60 miles or so northwest of there and

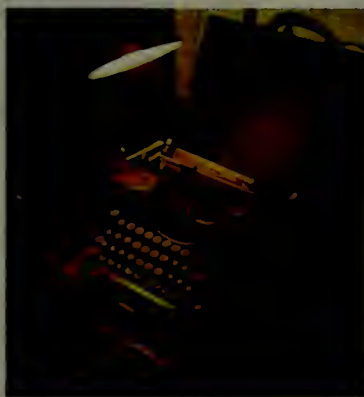
WORDSMITH Faulkner's Underwood typewriter on display in his office on the first floor

size. Hodding Carter, David Cohn, Shelby Foote, and W.A. and Walker Percy are among its native sons. "It's in the water," jokes Hugh McCormick, who will sell you a bottle at his bookstore, McCormick Book Inn. Also stop by the W.A. Percy Memorial Library to see authors' photos and papers.

Next on your tour, about an hour up the road, you'll find Clarksdale, where playwright Thomas Lanier "Tennessee" Williams spent his formative years. He lived in the Old St. George Rectory at 106 Sharkey Ave. with his grandfather, Reverend Walter Dakin. Williams said the high ceremony of the Episcopal church was his first introduction to theater. A few blocks away, on Clark Street, you'll spot the home of Blanche Clark Cutrer, the model for Blanche DuBois in *A Streetcar Named Desire*.

Your final stop is about 45 minutes away, in Oxford, where you can visit William Faulkner's 33-acre estate, Rowan Oak. It's a short but spooky walk through the woods from the University of Mississippi campus. Preserved on the first floor of Faulkner's antebellum house is his office, where you'll find his portable Underwood typewriter and the outline for *A Fable* scrawled on the wall.

Wander around Courthouse Square to see many of the places mentioned in Faulkner's work as well as a bronze of the author seated on a bench in front of City Hall. Bring a pen and paper and sit a spell. Maybe Mississippi will be your muse as well. ■



Europe

Packages, cruises, and discount Web sites can help you stretch those euros. **BY SUSAN GARLAND**

AH, SPRINGTIME IN Paris. Well, perhaps not this spring. Although the dollar has recently gained about 5% against the euro, Europe is still an expensive proposition for Americans.

But if you're determined to visit the Continent, you can find ways to keep spending below sticker-shock levels. You can shave costs by buying a prepaid package, considering less-trodden destinations, or traveling within Europe on budget airlines. "You won't get great deals in Europe, but you can be a smart traveler," says Chris Loughlin, a vice-president at Travelzoo, an Internet site that lists travel sales and links.

The first step on your journey: Visit travel Web sites to get a feel for sales, specials, and the variety of airfare, hotel, and car-rental rates. Each wholesaler cuts its own deals, so prices and offerings vary. Also, deals can change by the minute.

Although airline competition should keep ticket prices from getting out of hand, Amy Ziff, editor-at-large at Travelocity.com, says the lowest fares for warm-weather travel to Europe will be posted in early spring. "It will be wise to plan your trip a little early and take advantage of those springtime sales," Ziff says. "They tend not to last long."

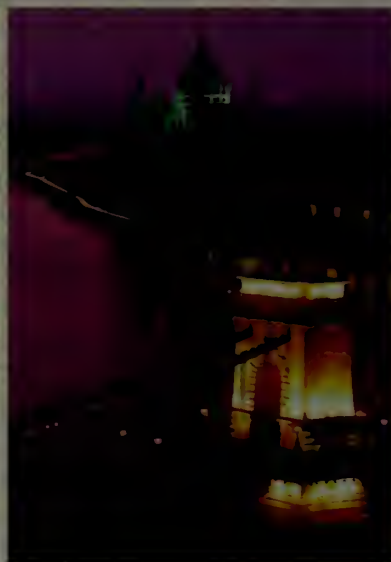
For hotels, look for deals by booking early or by lowering your standards of luxury. Although prices will likely rise as summer gets closer, three-star hotels and a smattering of four-star ones in Rome and Paris have been offering nightly rates under \$175 for June and July at sites such as activereservations.com and discount-hotels.com. Make sure the final price includes all taxes and service charges and

try to find hotels that include breakfast.

An air-hotel package is one of the most economical ways to go. Unlike past packages that offered a single flight and no choice of lodging, today's deals let you customize your vacation online by picking your travel dates and selecting among numerous flights and hotels at a bundled



BUDGET-FRIENDLY
(clockwise from top)
Boarding Ryanair,
Budapest at dusk,
and Porto, Portugal



price. For instance, in mid-February, CheapTickets offered two travelers wishing to leave on July 6 from Chicago to Rome a selection of 13 four-star hotels for six nights; the total air-hotel package ranged from \$2,753 to \$5,181, depending on which hotel is chosen.

Other sites worth checking are Travelzoo, Orbitz, Expedia, priceline.com, TripAdvisor, and go-today.com, as well as the airline sites. For luxury packages, Classic Custom Vacations, based in San

Jose, Calif., provides up to 50 counts, says Suzi LeVine, vice-president for sales and marketing.

All-inclusive cruises are another find value. Jan Swartz, senior vice president for sales and customer service at Line and Princess Cruises, says added European itineraries this summer new 12-day Mediterranean cruise from London to France, Italy, Portugal, and with a May departure starts at \$2,400 per person, not including airfare. Try searching for a cruise or barge deal by visiting rylink.com, an auction site that provides up to 40% off retail prices.

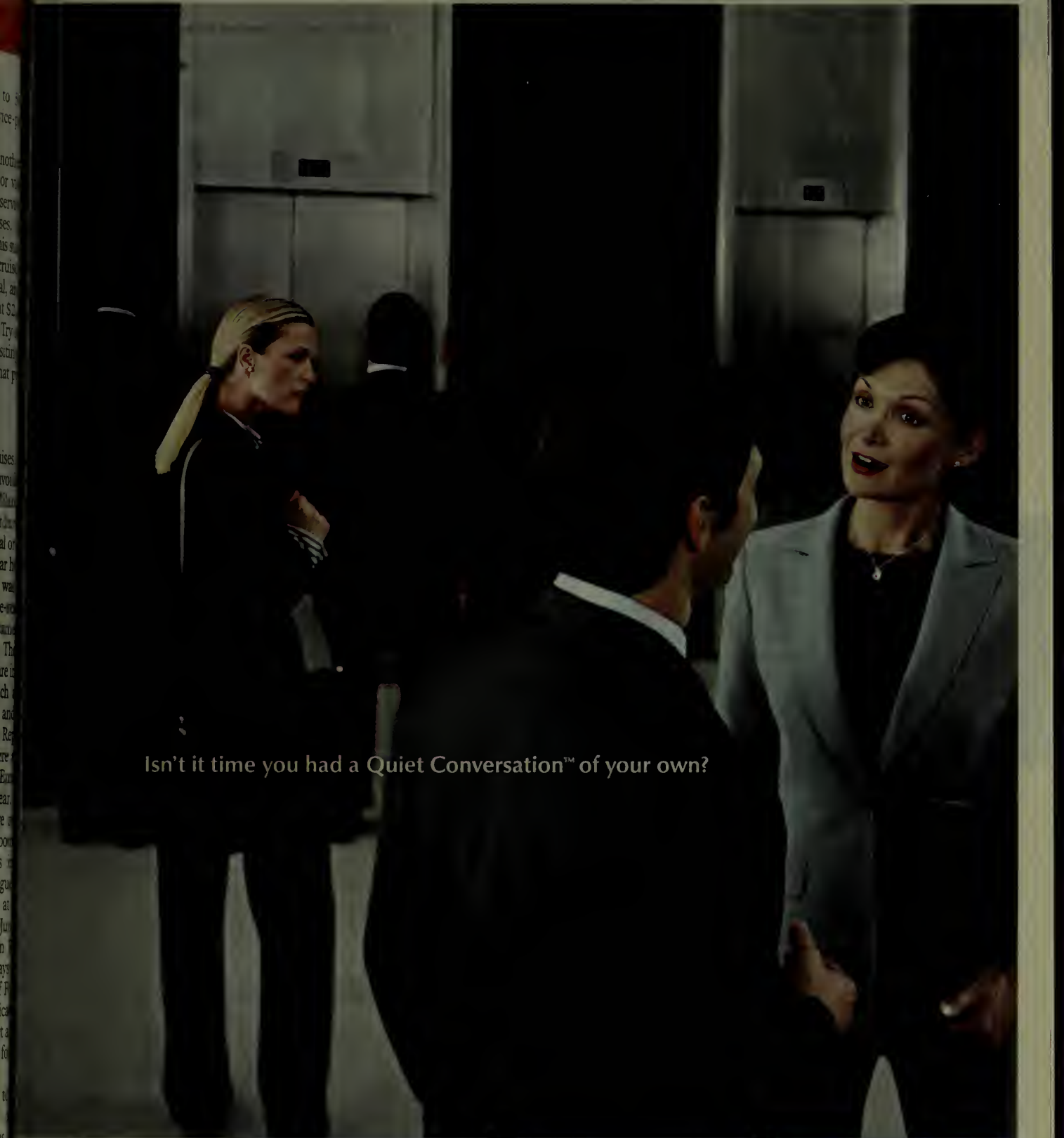
HEAD EAST

BEYOND PACKAGES AND cruises, travelers can stretch their euros by avoiding the highest-cost cities, such as Milan, London, and Rome. Instead, try Amsterdam,

Vienna or cities in Portugal or Spain. At Hotels.com, a four-star hotel in Paris for July 13 was \$332 with tax, while a five-star hotel in Amsterdam for the same dates was selling for \$174. The deals—while they last—are in eastern Europe, in cities such as Budapest, Krakow, Prague, and Warsaw. Although the Czech Republic, Hungary, and Poland were added to the European Union last year, their currencies have not been converted. Room rates at five-star hotels in Budapest and Prague listed recently at \$250 and \$325 for June, around \$500 in Rome. What's more, says Douglas Stallings of For Travel Publications, "You can still get a good meal in Prague for under \$10 per person."

If you intend to hop, fly on one of the no-frills airlines that have sprung up since the EU deregulated travel. A June 4 flight from Milan to Rome was posted at \$35, including tax, at ejet.com. Other low-cost carriers include bmibaby, ryanair.com, and SkyEurope. Despite the strong euro, travel experts expect Europe to be busy this vacation season. So if a deal looks good, don't wait around for a better one—grab it. ■

BusinessWeek online For a story on the Portuguese city of Porto, please visit us online at businessweek.com/extras.



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EDITED BY TODDI GUTNER

BEAUTY

A CHAIN THAT ZAPS ROGUE FOLLICLES

WE ARE OBSESSED with unwanted body hair. That explains why laser hair removal is now the most popular nonsurgical cosmetic procedure after botox. A Tampa company is even franchising the concept. **Ideal Image**, with nine centers in the Southeast offering nothing but hair removal, just announced

plans for 16 more across the U.S. by midsummer. About 18% of customers are men, says CEO Dean Akers. Usually they come to zap back hair, at \$4,000 to \$5,000 for five treatments. Women more likely want facial hair removed, which might cost \$700 to \$1,000.

The low-energy laser used to get rid of hair permanently targets the darker pigment in hair follicles. Patients usually experience only mild discomfort, but there is a risk of burns. So it's important to make sure a physician oversees the facility, says Dr. Jay Calvert, a Beverly Hills plastic surgeon. If the laser operator is not an M.D., the next best thing is a nurse or physician's assistant licensed to perform laser procedures. —Carol Marie Cropper



HEALTH

A Fat's Last Gasp?

HERE'S GOOD NEWS for those trying to cut down on unhealthy fat: Many foodmakers are reducing or eliminating the amount of artery-clogging trans fat in their products before Jan. 1, 2006. That's when a new **Food & Drug Administration** requirement for including trans fat on food labels kicks in. Products with zero trans already on the label include Tyson's chicken nuggets, patties, and tenders; ConAgra's Blue Bonnet; Fleischmann's, and Parkay soft spreads, Kraft's reduced-fat Oreos; Pepperidge Farm's Goldfish and other crackers; and Frito-Lay's chips.

Still, even "trans fat-free" products may not be totally rid of the stuff. Foods with less than 0.5 grams of trans fat per serving are allowed to round down to zero. If there's "partially hydrogenated" vegetable oil, there's trans, says Michael Jacobson, executive director of the nonprofit **Center for Science in the Public Interest**. Also look what replaced the trans. Palm oil is high in saturated fat, and both saturated and trans fat raise bad "LDL" cholesterol (trans also lowers good "HDL"). Canola, corn, soybean, and sunflower oils are healthier alternatives.

—Anne Terg

INVESTING

IF YOU'RE WAFLING about how much of your portfolio you should allocate to equities, **Mellon Capital Management (MCM)** has a recommendation: 100%. This is only the seventh time in 32 years that MCM has shifted its asset allocation to all stocks.

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May 1980	23.2	31.3
Mar. 1986	13.3	29.3
July 2002	2.4	12.3
Dec. 2002	11.8	28.7

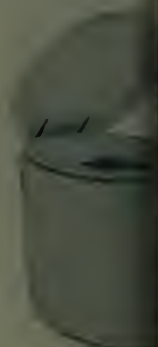
A sound economy, along with near all-time-high earnings and cash flow for companies in the Standard & Poor's 500-stock index, are driving MCM's recent move. It's worth noting that the S&P 500 returned 12.7% and 24.9% on average over the 6 and 12 months, respectively, following MCM's previous shifts to all stocks.

THE HOME

BELLE OF THE BATH

MAKING a fashion statement isn't only about the clothes. Now it's about your toilet.

Kohler's new Purist Hatbox toilet, unveiled in February during Fashion Week in New York, does away with the clunky tank, flusher handle, and familiar bowl. Instead, the simple elongated tankless design uses a sensor-driven electric pump to flush. The \$2,890 toilet comes in six colors and will be available nationwide by May (kohler.com).



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BY ROBERT BARKER

Stocks by the Barrel: Sizing Up the Oil Patch

Most of the world's energy titans by now have reported blowout 2004 profits. At ExxonMobil, net was up 18%. At BP, it was up 26%. Even net of troubled Royal Dutch/Shell was up 48%. With crude prices still riding high, they're all looking forward to more bounty. But if crude supplies stay tight, will these be the best oil stocks to hold?

Maybe not. Usually, investors' first focus is on sales and earnings. But unless substantial new supplies of crude oil are found to meet growth in demand from China and South Asia, investors may start to pay less heed to income statements and more to balance sheets. Or, more specifically, to every energy company's chief asset: proved reserves of oil and natural gas, the source from which future profits will flow. Veteran energy analyst Charles Maxwell of Weeden & Co. suggested to me recently that when investors shift their gaze from profits to reserves, "a new growth elite among energy stocks will emerge."

Plenty of people on Wall Street and in the industry disagree

with Maxwell's long-held and widely known view that net OPEC oil production is destined to peak around 2010. The chance he is right, however, can't be ignored. Which raises question: If investors begin focusing more on energy companies' reserves, which stocks would benefit?

TO TRY TO ANSWER THAT, I adapted and updated a ranking that Maxwell keeps of major energy stocks by proved reserves and market values. Instead of using stock market capitalization, as Maxwell does, I substituted total enterprise value to capture each company's net indebtedness along with equity value. Next, I surveyed 14 companies to collect the latest estimates of proved reserves. (For those, such as ExxonMobil, that won't report their yearend 2004 reserves until March, I used the latest available data.) Finally, following Maxwell's method, I worked a ratio to see how many barrels of oil-equivalent (a unit that equates natural gas to crude) each \$100 investment in one of these stocks buys.

The results are in the table. Royal Dutch/Shell recently its estimate of proved reserves. Yet its stock is nearing an time high. That's a double whammy by this measure—so \$100 invested in Royal Dutch/Shell buys just 5.8 barrels of oil-equivalent. Two leading peers, BP and ExxonMobil, also are trading near their highs, so they fare only a bit better. A sign of the times: ExxonMobil is so priced on Wall Street that it's set to overtake General Electric as No. 1 in market cap.

What stands out as a potential value? Two names that, despite being traded on the New York Stock Exchange, are much less familiar to U.S. investors: Brazil's Petróleo Brasileiro (Petrobrás), which has 18.6 barrels of oil-equivalent per \$100 investment, and Repsol YPF of Spain, with 12.3 barrels. Buoyed last year by discoveries offshore, Petrobrás added 1.3 barrels to proved reserves for each barrel that produced. That's in contrast to, say, BP, which replaced each barrel produced with less than 0.9 barrels. Repsol is poised to release its 2004 reserves data on Feb. 22.

This ranking doesn't account for the companies' many other strengths and weaknesses. ExxonMobil's AAA credit rating, for example, lowers its cost of capital. Or, as Royal Dutch/Shell's series of downward restatements of reserves show, assets can dry up fast. Just the same, if you believe, as I do, that barrels of oil are only becoming more precious, so will the stocks of those who have them. ■

E-mail: rb@businessweek.com

MEASURING FOR VALUE

COMPANY (SYMBOL)	RECENT PRICE	ENTERPRISE VALUE (BILLIONS)	OIL & GAS RESERVES (BILLIONS OF BARRELS*)	HOW MANY BARRELS A \$100 INVEST- MENT BUYS
Amerada Hess (AHC)	\$91.94	\$11.2	1.05	9.3
BP (BP)	60.96	243.1	18.60	7.6
ChevronTexaco (CVX)	96.79	120.9	12.00	9.9
ConocoPhillips (COP)	56.54	80.0	8.10	10.1
ENI (E)	121.27	92.2	7.27	7.9
Exxon Mobil (XOM)	55.58	353.3	22.00	6.2
Imperial Oil (IMO)	64.00	22.6	1.84	8.1
Marathon Oil (MRO)	41.48	18.2	1.14	6.3
Occidental Petroleum (OXY)	61.48	27.1	2.47	9.1
Petróleo Brasileiro (PBR)	45.66	64.0	11.82	18.5
Repsol YPF (REP)	25.58	44.0	5.43	12.4
Royal Dutch/Shell (RD)	58.09	223.5	12.95	5.8
Total (TOT)	108.58	143.6	11.40	7.9
Unocal (UCL)	49.84	15.4	1.75	11.4

*Oil & Gas Reserves include oil, natural gas, and natural gas liquids reserves, rounded as a multiple of 100,000 barrels.
Data: www.burroughs.com; Weeden & Co.; BusinessWeek

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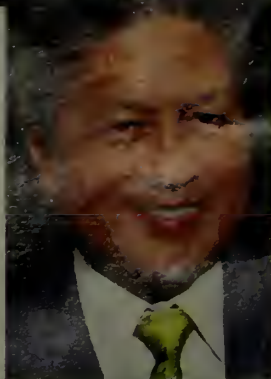
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BY GENE G. MARCIAL

EMPTY MERGER TALK HAS INFLATED MAY DEPARTMENT STORES

A NEW IKON OFFICE STAKEHOLDER COULD GIVE IT A BIG SHAKE

INSULIN DEVICES FROM ANIMAS ARE GRABBING J&J'S ATTENTION

May: A Stock to Short?

WITH THE RASH OF MERGERS among big retail chains, investors in May Department Stores (MAY)—plagued by poor sales for the past few years—are betting it will get bought out by Federated Department Stores. But those in the know say talks between the two companies have been scrapped because of disagreement over price. “No other suitor will rescue May at its current inflated price,” says industry expert Gilbert Harrison, chairman of Financo, a mergers and acquisitions boutique specializing in retail and merchandising deals. May owns 400 stores in 37 states, among them Lord & Taylor, Marshall Field’s, and Filene’s. Investors racing to catch the next deal “shouldn’t be taken in by all the hype,” says Harrison. The sharp rise in stocks of suspected targets have all but foiled many possible deals, he adds. Though his firm does not short stocks, he thinks May shares have

become so overvalued that the stock is an ideal short. It’s surged from 23 in mid-October to 32—not far off its 52-week high of 36. May’s financial profile, he notes, shows zero growth, with flat sales and profits since 2002. The stock deserves a price 10% to 20% below its current price, he figures. It’s unusual for Harrison to recommend shorting a stock, since his bread-and-butter business is putting companies together. But he thinks May will be a bad bet for some time. Researcher Gimme Credit sees “more downside than upside potential” for May as fundamentals weaken. Standard & Poor’s recently revised its outlook to negative, stable because of declining same-store sales. It cut its earnings estimate by 20¢, to \$2.15 a share, for the year ending Jan. 3, 2006, vs. 2005’s \$1.82. May and Federated declined comment.



HARRISON Skeptical

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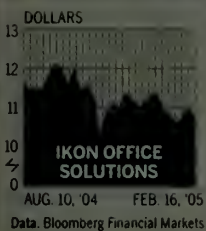


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ting Steel in Ikon's Spine

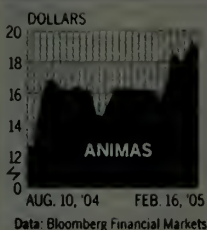
STEEL PARTNERS HAS A HISTORY of buying big stakes in companies, pushing to maximize their value, and then putting them in play. Early on, Steel Partners was featured in the front page of the Wall Street Journal after taking a 29% stake in Ikon International. By August of that year, Ikon had been acquired by Cubic. Ikon's latest buy: Ikon Office Solutions, in which it has acquired a 5.4% stake. Ikon is the No. 1 independent manufacturer of copiers and printers—Canon, Hewlett-Packard, Ricoh, and Xerox Minolta. In its filing with the Securities & Exchange Commission, Steel Partners explained that, with Ikon so undervalued, it seeks board seats, buy additional shares, and propose to boost earnings. Matthew Troy of Smith Barney sees Ikon earning 65¢ a share in the year ending Sept. 30, 2005, up from 52¢ in 2004, vs. 72¢ in 2004. Now at 10.71 (book value is 10.71), Ikon is worth 15, says a New York hedge-fund manager who owns shares.

PERKING UP SMARTLY



fund managers, who have bought shares. Animas pumped up from 12 in August to 19.31 in early February, before easing to 18.74. There is more behind their buying: They expect that Johnson & Johnson, which owns 8.2% of the company, will opt to buy all of Animas, which has just launched a new version of its pump that checks food intake, calculates the carbs ingested, and dispenses the correct insulin dosage. Other major medical-device companies, such as Roche, Abbott Labs, and Medtronic, have both insulin pumps and test strips that measure sugar levels. J&J has the test strips but depends on Animas for pumps through a "cooperative marketing arrangement." The hedge-fund pros, who asked not to be named, expect J&J to make a move before yearend. "The pressure is rising for J&J to compete head-on in insulin pumps," says one. Lynn Pieper of Thomas Weisel Partners, who tags the stock "outperform," has a 12-month target of 24, based on six times her 2005 estimated sales of \$83 million, up from 2004's \$67.9 million. She expects 2005 profits of 16¢ a share, vs. a loss of \$1.23¢ in 2004. Animas CEO Katherine Crothall says every company with a test strip has a strategic need for an insulin pump. J&J didn't return calls. ■

A STEADY RISE



J May Pump Up Animas

ANIMAS (PUMP), a little-known maker of small glucose pumps—to let diabetics constantly monitor the sugar in their blood—could take a big share of the continuous measurement market. So say two New York hedge-

BusinessWeek online

Gene Marcial's Inside Wall Street is posted at businessweek.com/today.htm at 5 p.m. EST on the magazine's publication day, usually Thursdays.

Note: Unless otherwise noted, neither the sources cited in Inside Wall Street nor their firms hold positions in the stocks under discussion. Similarly, they have no investment banking or other financial relationships with them.

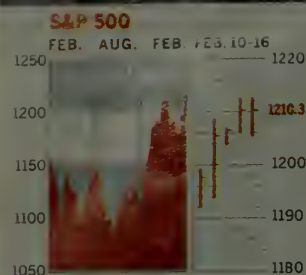
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STOCKS



COMMENTARY

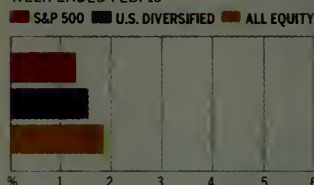
Greenspan's testimony before the Senate on Feb. 16 tripped up the bond market. He said the economy had "firmed" and that rates were too low. Equities sagged a bit at first, but bounced back. Meanwhile, Apple Computer's stock split was music to shareholders' ears: shares soared. And oil giant Exxon Mobil set new highs thanks to gushing profits.

Data: Bloomberg Financial Markets, Reuters

MUTUAL FUNDS

4-WEEK TOTAL RETURN

WEEK ENDED FEB. 15



52-WEEK TOTAL RETURN

WEEK ENDED FEB. 15



Data: Standard & Poor's

U.S. MARKETS

	FEB. 16	WEEK	% CHANGE YEAR TO DATE	LAST 12 MONTHS
S&P 500	1210.3	1.5	-0.1	5.6
Dow Jones Industrials	10,834.9	1.6	0.5	1.9
NASDAQ Composite	2087.4	1.7	-4.0	1.6
S&P MidCap 400	667.1	2.1	0.6	10.8
S&P SmallCap 600	330.8	2.0	0.6	17.6
DJ Wilshire 5000	11,922.9	1.6	-0.2	6.7

SECTORS

BusinessWeek 50*	723.2	2.8	2.6	13.9
BW Info Tech 100**	362.9	1.6	-2.8	0.5
S&P/BARRA Growth	581.3	1.7	-0.1	1.8
S&P/BARRA Value	624.7	1.4	-0.1	9.5
S&P Energy	330.2	6.2	14.4	41.8
S&P Financials	408.1	0.6	-0.7	2.0
S&P REIT	139.6	1.7	-3.4	15.4
S&P Transportation	227.0	3.5	-6.0	7.9
S&P Utilities	148.8	1.1	5.1	24.1
GSTI Internet	161.8	1.9	-9.3	10.4
PSE Technology	758.2	1.9	-2.7	2.8

*Mar. 19, 1999=1000 **Feb. 7, 2000=1000

GLOBAL MARKETS

	FEB. 16	WEEK	% CHANGE YEAR TO DATE
S&P Euro Plus (U.S. Dollar)	1388.6	2.3	-0.8
London (FT-SE 100)	5053.2	1.3	5.0
Paris (CAC 40)	4009.0	1.0	4
Frankfurt (DAX)	4368.8	0.4	2.6
Tokyo (NIKKEI 225)	11,601.7	1.1	1
Hong Kong (Hang Seng)	14,015.5	1.2	-1.5
Toronto (S&P/TSX Composite)	9639.6	2.5	4.3
Mexico City (IPC)	13,640.8	-0.2	5.6

FUNDAMENTALS

	FEB. 15	WEEK AGO
S&P 500 Dividend Yield	1.93%	1.93%
S&P 500 P/E Ratio (Trailing 12 mos.)	19.7	19.6
S&P 500 P/E Ratio (Next 12 mos.)*	16.4	16.3
First Call Earnings Revision*	-0.8%	-0.76%

TECHNICAL INDICATORS

	FEB. 15	WEEK AGO
S&P 500 200-day average	1138.6	1136.6
Stocks above 200-day average	77.0%	76.0%
Options: Put/call ratio	0.74	0.70
Insiders: Vickers NYSE Sell/buy ratio	4.16	4.31

BEST-PERFORMING GROUPS

	LAST MONTH %		LAST 12 MONTHS %
Oil & Gas Refining	19.4	Fertilizers & Ag. Chems.	80.7
Constr. & Engineering	19.3	Oil & Gas Refining	76.1
Integrated Oil & Gas	14.7	Steel	74.7
Steel	14.6	Constr. & Engineering	55.0
Oil & Gas Exploration	14.0	Oil & Gas Exploration	54.6

WORST-PERFORMING GROUPS

	LAST MONTH %		LAST 12 MONTHS %
Internet Retail	-18.2	IT Consulting	
Tires & Rubber	-9.7	Electric Mfg. Svcs.	
Communication Equip.	-8.3	Insurance Brokers	
Auto Parts & Equipment	-6.5	Semiconductors	
Paper Products	-6.3	Semiconductor Equip.	

EQUITY FUND CATEGORIES

4-WEEK TOTAL RETURN	%	52-WEEK TOTAL RETURN	%
LEADERS		LEADERS	
Latin America	10.8	Latin America	37.2
Natural Resources	8.3	Natural Resources	34.2
Diversified Emerg. Mkts.	6.4	Utilities	22.3
Europe	4.9	Real Estate	22.0
LAGGARDS		LAGGARDS	
Health	-0.7	Precious Metals	-8.5
Japan	-0.6	Technology	-6.9
Communications	-0.6	Health	0.2
Technology	0.1	Large-cap Growth	2.2

EQUITY FUNDS

4-WEEK TOTAL RETURN	%	52-WEEK TOTAL RETURN	%
LEADERS		LEADERS	
ProFunds Oil & Gas Inv.	15.8	ProFunds Oil & Gas Inv.	58.8
U.S. Gbl. Invs. Gl. Rscs.	15.3	BlackRock Gl. Res. Inv. A	55.3
iShares MSCI Brazil Idx.	14.3	iShares MSCI Austria Idx.	47.6
CGM Capital Development	12.4	Metzler/Pdn. Eur. Em. Mkt.	46.8
LAGGARDS		LAGGARDS	
ProFds. Intnet. Ultsr. Inv.	-10.4	Ameritor Investment	-45.7
Tocqueville Sm. Cap Value	-7.5	ProFunds Semicdr. Inv.	-33.2
Munder NetNet A	-7.0	Van Wagoner Sm. Cap Gr.	-30.7
Apex Mid Cap Growth	-7.0	Apex Mid Cap Growth	-30.3

INTEREST RATES

KEY RATES

	FEB. 16	WEEK AGO
Money Market Funds	1.94%	1.94%
90-Day Treasury Bills	2.57	2.52
2-Year Treasury Notes	3.40	3.35
10-Year Treasury Notes	4.15	3.98
30-Year Treasury Bonds	4.52	4.37
30-Year Fixed Mortgage†	5.55	5.60

†BancQ

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	10-YR. BOND	30 YR.
General Obligations		
Taxable Equivalent	4.94	
Insured Revenue Bonds		
Taxable Equivalent	5.06	

THE WEEK AHEAD

CONSUMER CONFIDENCE

Tuesday, Feb. 22, 10 a.m. EST » The Conference Board's February consumer confidence index is forecast to have held fairly steady at 103. That's the median forecast of economists polled by Action Economics. In January, the index rose to 103.4.

CONSUMER PRICE INDEX

Wednesday, Feb. 23, 8:30 a.m. EST » January consumer prices for goods and services

probably rose 0.2%, after a 0.1% dip in December. Excluding food and energy categories, prices most likely moved up by 0.2% for a fourth consecutive month.

DURABLE GOODS ORDERS

Thursday, Feb. 24, 8:30 a.m. EST » Orders for durable goods in January very likely grew 0.2%, following a 1.1% jump in the prior month.

GROSS DOMESTIC PRODUCT (REVISED) Friday, Feb. 25,

8:30 a.m. EST » Real gross domestic product probably grew at an upwardly revised annual rate of 3.5% in the fourth quarter. The initially reported increase was 3.1%. Foreign trade should be a smaller drag than first calculated.

EXISTING HOME SALES Friday, Feb. 25, 10 a.m. EST »

January home sales are expected to have hit an annual rate of 6.75 million, after slipping to a rate of 6.69 million in December.

The BusinessWeek production declined to 238.2 for the week Feb. 5 but came in 12.2% above year-ago level. Before calculating the four-week moving average index rose to 236.9.

BusinessWeek online

For the BW50, more investment data, and the components of the production index visit www.businessweek.com/magazine/ext

the Companies

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How Bush's Budget Goes Wrong

THERE'S GOOD, BAD, and just plain ugly in President Bush's \$2.57 trillion federal budget proposal. The spending restraint is welcome, but the fiscal sleight of hand is not. The goal of cutting the deficit by the end of his term is laudable, but the legacy of soaring debt for Presidents to follow is not. Many programs targeted for cuts deserve them, yet many others do not. The President's proposal is a negotiating document presented to Congress. There's plenty of time to fashion a better budget. Here's how:

■ **Cut deeper.** The President's proposed \$8.2 billion in cuts over 10 years for farm programs is way too low. In his first term, Bush showered agri-corporations with money. Ending subsidies to big cotton and rice farmers, in particular, would boost imports of the crops from Pakistan, Egypt, and other parts of the Middle East, raising incomes overseas and discouraging terrorism. The President wants to take \$60 billion out of Medicaid. Rather than cut health care for the poor, he should reform the new Medicare drug benefit, which has unfunded liabilities three times that of Social Security. The 10-year price tag of the drug benefit has nearly doubled to \$724 billion and the President still threatens to veto any changes. At the least, Medicare should be permitted to bargain directly with major drug companies, as the Veterans Affairs Dept. already does. That could save billions.

Leave Medicaid alone. Focus on Medicare drug benefits

■ **Cut differently.** The budget proposal calls for ending the \$1.2 billion annual subsidy for Amtrak, the national passenger rail service. Yet it hikes highway spending enormously, to \$284 billion over six years, from the current \$218 billion. Cutting the largest pork-barrel program in Washington would curb the deficit and still allow for support for public transportation. And paring

multibillion-dollar spy satellite programs could free up more money for on-the-ground intelligence-gathering and preserve federal money for 100,000 police officers.

■ **Cut honestly.** The President's budget does not include new spending for the Iraq occupation, borrowing for the proposed Social Security private accounts, or ending the alternative minimum tax. Iraq will cost \$82 billion in the next fiscal year alone. Private accounts will cost \$1 trillion to \$2 trillion over the next 10 years and \$2 trillion to \$3 trillion in the next decade. The number of taxpayers hit with the AMT will increase fivefold in 2006, with the tax falling on families with annual incomes of \$100,000 to \$500,000. Ending the AMT will cost upwards of \$1 trillion over 10 years.

■ **Cut less.** The deficit morass is due as much to a revenue shortfall as excessive spending. Keeping taxes low on capital gains and dividends fosters investment and economic growth. Lowering income tax rates provides greater incentives to work. But cutting all taxes on estates of the very, very rich is neither. An estate tax that protects families, small farmer businesses can still generate tens of billions of dollars in revenues. Letting lapse the income tax cut of the highest income bracket could also generate billions of dollars of revenue that could pay for the teachers and emergency fire responders who will lose their jobs under budget proposals to reduce federal aid to cities. The budget also calls for cuts in Food & Drug Administration inspections of imported food and medicine—right after a British plant supplying half the flu vaccine to the U.S. was closed due to contamination.

President Bush didn't veto a single spending bill in his term. Indeed, he promoted some of the most expensive legislation in the nation's history even as he was sharply reducing the means to finance it. If he is now serious about fiscal restraint, he and Congress must show it.

Corporate Profits: Spend Them Wisely

CORPORATE PROFITS have been on a tear. Earnings for the 900 companies in *BusinessWeek's* Corporate Scoreboard rose 25% in the fourth quarter of 2004, far surpassing earlier estimates. Last year was the first time profits rose above their boomtime peak in 2000 (page 88). Companies are flush with nearly \$1 trillion in cash, and they are itching to put it to work.

For some, maybe too itchy. Chief executives are choosing between raising dividends or doing deals, and history shows that the stock market rewards dividend givers and punishes most dealmakers. While the current wave of deals is a welcome boost for Corporate America, CEOs should be wary. In the 20 largest deals since 1995, the average combined company underperformed the market by nearly 13%.

Judging by the record amount of dividends paid out last year, most CEOs know their history. Standard & Poor's estimates that cash dividends will set another record in 2005, up 12%, to \$203 billion, from \$181 billion in 2004. Chief executives are also using more of their cash flow to finance capital spending, which was up 18% for the fourth quarter and 9% for the year. It shows few signs of slowing down.

And, of course, a growing number of CEOs are doing deals. So far, many make sense. Companies are paying modest premiums, bolstering their core businesses, building scale, and integrating new operations carefully. But some deals appear problematic. It's good that profits are piling up. It's even better to use them wisely.

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